NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

Congressional Information Service, Inc.
Washington, D.C.

CIS

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

PART 1

JANUARY 19, 20, 26, AND 27, 1982

Printed for the use of the Joint Economic Committee

94-586 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1982

J84-44

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

HOUSE OF REPRESENTATIVES

HENRY S. REUSS, Wisconsin, *Chairman*
RICHARD BOLLING, Missouri
LEE H. HAMILTON, Indiana
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
FREDERICK W. RICHMOND, New York
CLARENCE J. BROWN, Ohio
MARGARET M. HECKLER, Massachusetts
JOHN H. ROUSSELOT, California
CHALMERS P. WYLIE, Ohio

SENATE

ROGER W. JEPSEN, Iowa, *Vice Chairman*
WILLIAM V. ROTH, JR., Delaware
JAMES ABDNOR, South Dakota
STEVEN D. SYMMS, Idaho
PAULA HAWKINS, Florida
MACK MATTINGLY, Georgia
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

JAMES K. GALBRAITH, *Executive Director*
BRUCE R. BARTLETT, *Deputy Director*

CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, JANUARY 19, 1982

Page
Reuss, Hon. Henry S., chairman of the Joint Economic Committee: Opening statement ... 1
Leontief, Wassily, professor, New York University, and 1973 Nobel Laureate in Economics ... 2
Tobin, James, professor, Yale University, and 1981 Nobel Laureate in Economics ... 27
Klein, Lawrence R., professor, University of Pennsylvania, and 1980 Nobel Laureate in Economics ... 33

WEDNESDAY, JANUARY 20, 1982

Reuss, Hon. Henry S., chairman of the Joint Economic Committee: Opening statement ... 51
Bosworth, Barry, senior fellow, Brookings Institution, Washington, D.C ... 52
Evans, Michael K., president, Evans Economics, Inc., Washington, D.C ... 55
Rahn, Richard W., vice president and chief economist, Chamber of Commerce of the United States, Washington, D.C ... 77
Sinai, Allen, senior vice president, Data Resources, Inc., Lexington, Mass ... 87

TUESDAY, JANUARY 26, 1982

Reuss, Hon. Henry S., chairman of the Joint Economic Committee: Opening statement ... 147
Mattingly, Hon. Mack, member of the Joint Economic Committee: Opening statement ... 149
Volcker, Hon. Paul A., Chairman, Board of Governors of the Federal Reserve System ... 152

WEDNESDAY, JANUARY 27, 1982

Reuss, Hon. Henry S., chairman of the Joint Economic Committee: Opening statement ... 191
Brown, Hon. Clarence J., member of the Joint Economic Committee: Opening statement ... 191
Regan, Hon. Donald T., Secretary of the Treasury ... 195

SUBMISSIONS FOR THE RECORD

TUESDAY, JANUARY 19, 1982

Leontief, Wassily: Prepared statement, together with an attachment ... 10

WEDNESDAY, JANUARY 20, 1982

Evans, Michael K.: Prepared statement ... 61
Rahn, Richard W.: Prepared statement ... 80
Sinai, Allen: Prepared statement ... 96

TUESDAY, JANUARY 26, 1982

Page
Abdnor, Hon. James: Opening statement 150
Bentsen, Hon. Lloyd: Opening statement 151
Hawkins, Hon. Paula: Opening statement 151

WEDNESDAY, JANUARY 27, 1982

Abdnor, Hon. James: Opening statement 194
Hawkins, Hon. Paula: Opening statement 194
Regan, Hon. Donald T.:
    Prepared statement 202
    Response to written questions posed by Senator Hawkins 253
Rousselot, Hon. John H.: Opening statement 193

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 19, 1982

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representative Reuss.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; and Keith B. Keener and Paul B. Manchester, professional staff members.

Opening Statement of Representative Reuss, Chairman

Representative **Reuss**. Good morning. The Joint Economic Committee will be in order for the opening of our 1982 hearings on the state of the economy and our inquiry into economic policies for this year and the years ahead.

For this first hearing we extended an invitation to the American recipients of the Nobel Prizes in economic science. We are very honored to have with us today three of the most distinguished of that very distinguished group: Prof. James Tobin, of Yale University, accepting the 1981 prize; Prof. Lawrence Klein, of the University of Pennsylvania, Wharton School of Finance, the 1980 winner; and Prof. Wassily Leontief, of New York University, who received the prize in 1973.

The year 1982 has begun without trumpets, to say the least. In the short run we are in a deep recession: unemployment around 9 percent; and without any policies in place to help restore noninflationary growth. Over the long run, we face the indefinite and intolerable prospects of a combination of high deficits, high unemployment, high interest rates, and high inflation unless economic policies are changed.

Our witnesses today will address both the short run and the longer run aspects of our economic dilemma and we have encouraged them to go wherever their interests take them.

Professor Leontief, we are, as always, so honored to have you with us, looking so young and hardy, and would you start out, sir? We have received prepared statements from all the witnesses and under the rule and without objection they will be placed in full in the record. And now will you proceed in any way you wish.

STATEMENT OF WASSILY LEONTIEF, PROFESSOR, NEW YORK UNIVERSITY, AND 1973 NOBEL LAUREATE IN ECONOMICS

Mr. Leontief. Mr. Chairman, I have accepted the invitation to take part in these hearings with great pleasure but not without some hesitation. What I have to say challenges not only the prevailing public attitude toward these problems in the United States but also the judgment of, I would say, a great majority of my professional colleagues.

The public seems to accept without demurring the rapid dismantling of Government machinery and the limiting of its functions to those intended by the Founding Fathers to serve the needs of the simple, agricultural community that this country was 200 years ago. The professional opinion—except that of a small but very vocal group of libertarian economists—continues to favor economic policies which are supposed to maintain the equilibrium and secure the growth of an increasingly complex and highly vulnerable modern economy through skillful manipulation of a few instruments; such as budgetary deficits or surpluses, selectively adjusted tax rates, interest rates and monetary supply controlled by the central bank.

The theoretical justification of the many different varieties of such policies—each representing one of the few basic themes composed of the same five or six different notes—is usually provided in the form of Phillips Curves, Laffer Curves, full employment budgets, rational expectation theorems and other types of more or less complicated theoretical constructs. The factual validation and implementation of these theories is based on what is often referred to as casual empiricism or on construction of more and more intricate econometric models. In these models, increasingly ingenious but still utterly unreliable methods of indirect—I underline indirect—statistical inference are employed in vain to compensate for the lack of hard, systematically organized factual information.

While experimentation with such policies is going on, the performance of the economy is steadily deteriorating. A year ago when President Reagan unveiled his first budget I observed "If Mr. Reagan's Policies Flop, Then What?" New York Times, February 22, 1981, that the proposed combination of drastic tax cuts with unprecedented tightening of credit will very likely bring about a slump threatening to lead into a deep depression. As could have been expected despite all the tax concessions the heralded spurt in productive investment failed to materialize.

Would a refinement of the old, or development of the new theoretical schemes, redefinition of M_1, M_2, or M_{10} that has to be controlled by the Federal Reserve really turn the failure of economic policies, based on present day academic economics, into at least a modest success? Can one really believe that efforts to increase the reliability of econometric forecasts through further refinement of already highly sophisticated statistical procedures or marginal improvements in construction of aggregative indexes, that are supposed to pinpoint the day and the hour on which a recession has stopped and recovery began, would do the trick? I doubt this and so I think does the American public, for what it seems to approve of in President Reagan's program is not the supply theoretical or monetarist approach intended to provide its rationalization, but rather the enthusiasm with which he proceeded to dismantle governmental organizations that might be capable of implementing active national economic and social policies of any kind.

The captain is dismissing a large part of his crew and has ordered the sails set so that the canvas would catch the full force of the wind, that is, that means pursuit of the highest possible profits. He also has directed the helmsman to take his hand off the tiller so that, unimpeded by an attempt to steer it, the ship could sail in the direction in which the wind happens to propel it. Most passengers seem to be enjoying the beginning of the cruise except, of course, the poor, the old, and the sick who are being lowered in leaky dinghies overboard. This, the captain explains, has to be done to lighten the load.

But the mood will change, and I think quite soon when everyone hears and feels the rocks scraping the bottom of the vessel. Emergency measures will certainly be taken, but after having been pulled out into deeper water, should we resume experimentation with the same kind of policies based on the same kind of theories that permitted the American economy to reach the stage in which it finds itself today? Let's hope not. The waters that we are about to enter are much more treacherous than those we were navigating up until now. The living space available for our growing and more and more heterogeneous population is slowly but steadily narrowed by the gradual exhaustion of natural resources on one side and on the other side by costly measures that will inevitably have to be taken to arrest progressive environmental degradation.

The inadequacy of the trial and error approach that still dominates the formulation and implementation of our national economic policies will become quite clear when the time comes to meet the full force of the economic and social impact of the rising wave of new technology.

The interdependence between all different sectors of a national economy is bound to grow with the increase in the complexity of their internal structures and the rise in the scale of operations. Many projects initiated today will come to full fruition only in 10, 15, or even 20 years from now, and their ultimate success will depend critically on effective coordination with interrelated development in all other branches not only of our economy but also with developments in all other parts of the world. Corporate decision-making in this country, while effective so far as it goes, cannot afford to reflect a long-run point of view; the chief executives lose their jobs if profits sag during three successive quarters. Hence, there cannot be coordination in this country between investments and technological developments in different sectors such as is being carried out so effectively in Japan and a few Western countries. Over the past 10 years American corporations earned an average of 18 percent on their investments per year, while their Japanese counterparts only 11 percent. This means that in the United States, corporate management is so cautious that it refuses to move until it can count on recovering newly invested capital in 4½ years. Its counterparts in Japan are prepared to wait for 11 years. No wonder they continue to expand old and construct new plants while large U.S. corporations prefer to maintain liquidity and to diversify their investments by buying up each other's stocks.

I just read today in the paper that Coca-Cola decided to run the movie industry as opposed to the movie industry trying to run Coca-Cola. It's not reinvestment; just diversification.

Much is being said about the necessity to compensate investors for high risks they take, but not enough about reducing risks. One and possibly the only effective way of reducing risk—besides taking out insurance that simply redistributes it without diminishing its total level—is systematic coordination based on long-range foresight—that is, planning. I use that word although I know that there are some who reach for the gun when they hear it.

The planning approach to formulation and implementation of economic policies is less simplistic than the hit-and-miss approach; it is more ambitious and because of that also more difficult. To put it into practice it is not enough to possess a theoretical understanding of the general principles on which the economic system works. The planning approach requires a rather detailed practical knowledge of the structural characteristics of all sectors of a particular national economy and an accurate assessment of the mutual interrelationships between levels of production and investment in all its branches. Moreover, under a planning approach, coordinated policy measures are put into effect not only in response to current difficulties, but often are instituted as anticipative action designed to forestall future troubles. One cannot help but think in this connection of our automotive and our steel industries. Whose turn will it be next?

Formulation and implementation of planning policies requires a systematic appraisal of internal and external forces that can be expected to affect the operation of the economy in the future—at least in the foreseeable future; a future which can stretch as far ahead as 20 years and in some instances, such as population growth, much further. It's not surprising that the general idea of economic planning was advanced much earlier than technical capabilities to implement it became available. The development of governmental statistical services first centering on compilation of national income accounts and culminating in construction of more and more detailed input-output tables paved the way for the creation of the requisite data base. However, it is only with the emergence and the gradual perfection of formal methods for studying intersectoral relationships—which coincided with the development of more and more powerful computers—that placed in the hands of the policymaker necessary analytical tools. These he can use not only to identify the internal and external changes that can be expected to affect the functioning of each individual sector of the national economy in its relationship to all its other branches, but also to assess in some detail, the direct as well as the less obvious indirect effect of corrective measures that might be proposed.

At the present time it is the inability—or occasionally the reluctance of official statistical organizations—to collect and systematize large masses of readily available specialized information, not the lack of analytical tools, that seems to hinder effective practical implementation of the planning as contrasted with the traditional trial and error approach to policy formation in the economic field.

The United States is the only advanced, industrialized country that still does not possess a real, central statistical office responsible for collection, systematic organization and dissemination of facts and figures pertaining to population, natural resources, technology and other aspects of the national economic life and social life. As things stand now, each department and each agency of the Federal and of most local governments compiles data of one sort or another that it happens to need or has needed in the past in connection with the discharge of its administrative or regulative responsibilities. While it collects and publishes more data than any other agency of the Government, the Bureau of the Census is not a real central statistical office. Confronted with a giant jigsaw puzzle, economists and statisticians working in the Government or private business, as well as those engaged in academic research, spend a large part of their time trying to put its pieces together—that is, to reconcile incompatible figures coming from different sources and to fill as well as they can the gaping holes in the total picture.

What a contrast with the statistical organization of Japan or even that of a small country like Norway which has decided recently to discontinue its census because, as it was explained to me, all data needed for government planning, business planning, and independent research are collected, systematized, and brought up to date continuously, month by month and year by year. The compilation of a decennial U.S. input-output table is assigned to a small team tucked away in one of the many bureaus of the Commerce Department; its printed version consists of two modest 150-page-thick paperback pamphlets. The compilation of the most recent Japanese input-output table was carried out by the combined effort of 13 ministries under the general supervision of a committee of the Council of Ministers. The amount of information presented in five hard-cover volumes—I would like to bring them here if I could carry them—containing the Japanese table is several times larger than its U.S. counterpart and was compiled in about half as much time.

Creation and maintenance of a comprehensive data base would permit a drastic reduction in the amount of guesswork, and one might add, of idle theorizing that is involved in our policymaking process now. But as I said before, providing the requisite data base is not enough. The time has come to take a decisive step by setting up a strong, autonomous research organization—I know it would require new legislation—analogous to the Congressional Research Services, but more authoritative and much larger, that would provide all branches and agencies of the Government with the technical support needed for developing a systematic, coordinated approach to development and practical implementation of national and local, general and sectoral economic policies.

This organization should also be responsible for monitoring in great detail developments in all parts of the United States economy, with emphasis on changes in their interdependence, and whenever necessary, on changes in the structure of the world economy. It should be able to identify the existing and anticipate the potential trouble spots. The analytical capabilities of this organization should be engaged not so much in futurist prediction but rather in elaboration of alternative scenarios each describing—with emphasis on sectoral and regional detail—the anticipated effect of any particular combination of national, regional, and local economic policies. This is, in fact, the only means by which the Government and the electorate at large would be enabled to make an informed choice among alternative policy actions.

While providing research support to legislators and administrators responsible for the overall direction of national economic policies, and assisting in the choice of appropriate methods for their practical implementation, the proposed technical organization should be involved in final decisionmaking only to the same limited extent as is, for instance, the Bureau of Labor Statistics in the Department of Labor, or the Bureau of Economic Analysis in the Department of Commerce. To discharge effectively the responsibilities assigned to it, this independent agency should, however, have a decisive voice in determining the direction and scope of the data-gathering activities of the Federal and, in some instances, on a consultative basis of State and local governments.

The data gathering and monitoring operations comprising also the formulation of alternative scenarios would eliminate or at least reduce to reasonable proportions one of the most wasteful and futile aspects of the present policymaking process which, for want of a better word, I call adversary fact finding. Studying the supposedly factual reports contributed by the interested parties, one cannot help but be reminded of testimonies presented by witnesses summoned by both sides before a judge trying to find out what has actually happened in an automobile accident. The policymaking process would be much more effective if it did not imitate a traffic court but rather were modeled along the lines of a formal arbitration procedure. The arbitrator first establishes the relevant facts and only after does he proceed to explore alternative paths toward a workable agreement.

In the questions which you raised in the letter describing what will be discussed here you asked me to mention the problems which we will be facing. I think the inefficiency of the present policymaking process is problem No. 1. Mr. Stockman's instructive interview in the Atlantic Monthly testifies to this.

Can I have a few minutes more?

Representative **Reuss**. As long as you want.

Mr. **Leontief**. I don't want too much. But, of course, you know when everyone discusses anything in these times—if one simply discussed what the weather would be next year—the question which always is raised is how will it affect inflation? So I couldn't possibly get away without saying something about inflation. That is what I think about.

Following Mrs. Thatcher's lead, the administration is trying to suppress inflation by beating the entire economy into the ground. There is an old joke about a gypsy who eked out a meager living by renting out the services of a horse he owned. One day he decided to increase the profitability of this enterprise by training the old nag gradually, step by step, to get by on smaller and smaller rations of oats. For a couple of weeks—I should say for a year now—the policy seemed to be succeeding very well until, to the poor chap's great surprise, the horse suddenly died.

Representative REUSS. Of course, the supply siders would say it was too bad about the horse but the sparrows did very well.

Mr. LEONTIEF. Oh, yes. That is absolutely the trickle-down system called the horses versus sparrows system. You feed the horse and the sparrows get something after a while.

Judging by past experience, what reason is there to expect after inflation has been suppressed at the cost of a prolonged and severe depression, the old hands with their Keynesian or monetarist policies will not be put again in charge, that prices will not again begin to rise and the familiar cycle be repeated?

Inflation that has been plaguing this and most—but notably not all—advanced free market economies cannot be suppressed by purely economic technical measures. While a proper combination of fiscal and monetary policies is indispensable for effective management of a modern economy, their success is predicated not only on tacit mutual understanding, but on institutionalized, day-by-day cooperation between business, labor, and Government.

Austria, a highly industrialized modern democracy, has successfully resisted inflationary pressure by means of such an institutional setup. The unemployment rates there are about 2 percent and the inflation horribly rose I think from 3 to 4. In the course of annual across-the-board negotiations between trade unions and employers' organizations, the Government plays the role of an impartial fact finder by providing detailed description—usually in terms of an input-output table—of the actual state of the national economy and a systematic analysis of the effects that a proposed settlement will have on the future growth of the economy.

I omit reading the specific example that I put in the prepared statement when the Austrians, as we do, faced a disaster to the newspaper industry and newspaper labor when the new technology processes were introduced which produced terrific unemployment. What they did was the Institute for Economic Studies, which is a part of the Academy of Sciences, made a very detailed study of technology and proposed to the employers and unions who worked together the problem of how to introduce this technology step by step and what to do with available labor, whom to retire, whom to retrain and so on. This process is practically completed. Negotiations were stiff, but there were no strikes and no lockouts. That problem was solved.

The present negotiations between the automobile workers unions and General Motors seem to point in the right direction. However, without an overall agreement between organized labor and organized business extended to all major sectors of the economy within the framework of a very carefully, comprehensive indicative—we call it a voluntary plan—separate actions of this kind will really not solve the problem. Moreover, so far as agreement on prices of automobiles, General Motors agreed not to increase the price of the automobiles. Let us not forget that it's not that agreement but the Japanese imports that will set the prices at which General Motors will have to sell its cars.

Now I come to the last point. You remember I said in the beginning the old problems I think will be repeated, all of them, so long as we don't change policy, but there will be one new problem and that is the challenge of modern technology and, to be more specific, the challenge of automation.

The average productivity of labor employed in a telephone exchange (measured by the total number of calls completed, divided by the total number of operators) rises as live operators are replaced by automatic switchboards. When only one operator remains on the job his average productivity becomes very high indeed and it becomes infinite when that last operator is discharged.

All previous technological so-called revolutions—except possibly in England in the 16th century there was a so-called enclosure movement when the landlords drove all farmers off the land because sheep were much more profitable than yeomen from the point of view of the landlord—enhanced the commanding role of labor as a dominant, indispensable factor of production. It maintained the demand for it, as compared to the demand for capital and natural resources, and thus secured reasonably full employment for the available labor forces at steadily increasing real wages.

Until the middle 1940's, a progressive shortening of the normal workday and workweek was accompanied by an increased standard of living. But at the end of World War II, the situation changed. Successive waves of technological innovation continued to overtake each other as before, and the real-wage rate continued to go up; but the length of the normal workweek today is practically the same as it was 35 years ago.

Machinery, however, continues to replace human labor. Some sectors of the economy are more affected by it than others. Some types of labor are replaced faster than others. Less-skilled workers, in many instances but not always, go first; skilled workers, later. Computers taking over the jobs of white-collar employees perform first simple and then increasingly complex mental tasks. I just introduced a word processor in my institute and I don't need as many secretaries.

While in many operations even dirt-cheap labor could not compete effectively with very powerful or very sophisticated machines, a drastic general wage cut could temporarily arrest the adoption of labor-saving technology. But unless their introduction is interdicted by specially erected barriers, the trend is bound to be resumed. Even a most principled libertarian might hesitate to have the wage level settled by cut-throat competition among workers under continued pressure of steadily improving labor-saving technology.

By controlling the total labor supply, powerful unions can and indeed did, fortunately, maintain wage rates, but as the efficiency of automatic equipment increases and its cost goes down, they will be facing the unenviable choice between continuous wage concessions and increasing chronic unemployment.

You know, Adam and Eve enjoyed a very comfortable life in Paradise without working. However, they broke some laws or rules or customs and were condemned to eke out a miserable existence in heavy toil and trouble, working from dawn to dusk.

The history of technological progress is essentially the story of the human race working its way slowly but steadily back into paradise. But what would happen if suddenly we found ourselves transported into Eden today? With all goods and services produced without work, no one would be gainfully employed and being unemployed under the present institutional arrangement means to receive no wages and, consequently, to have no regular income. Given such conditions, Adam and Eve would have found themselves starving in Paradise.

This fable points out the nature of the problem that we and other advanced societies will be facing in the coming years. Needless to say, unrestrained, uncontrolled working of the automatic market mechanism cannot be relied upon to provide an answer to it. A reasonable response toward incipient technological unemployment brought about by progressive mechanization and automation of all branches of production, transportation, trade, and most other service industries should aim at an equitable distribution of gradually shrinking employment opportunities, on the one hand, and of the gradually increasing national product, on the other. This product, however, will continue to rise only if the measures taken to that end will not obstruct directly or indirectly technological advance. In other words, to try to stop technological progress in order to protect employment would be fatal for any country, and certainly in a competitive market. Employment policies will have to be combined with income policies, and that is another word I would like to outline. Too often, by income policies, a man simply means to freeze wages and nothing else, and those I think will be as unsuccessful as permanent price controls.

The income policies I have in mind will be a complex and delicate combination of social and economic measures designed to supplement the income received by the blue- and white-collar workers for the sale of their services on the labor market, and sometimes even more modest income of independent craftsmen, professionals, and self-employed small entrepreneurs. We are already practicing income policies—certainly in our agriculture policies—by gradually changing the structure of our tax system, social security, medical insurance, welfare payments, and unemployment benefits. These are our income policies. Instead of being curtailed and decimated, these systems will have to be redesigned and expanded so as to reduce the contrast between those who are fully employed, partially employed, retired, or simply out of work.

Just to give a practical example, in very many other developed countries in Europe, for example, unemployment benefits are paid to partially employed people. The moment they work a little less they get some unemployment benefits, which seems to be a very rational arrangement, and the fact that it has to be financed, not out of really a fictitious insurance scheme, but out of the general revenues, is quite clear to everybody but our policymakers.

Mr. Chairman, having heard my observations and recommendations, you will certainly understand the hesitation with which I accepted the invitation to testify before you. As a minority opinion—and I know mine is a minority opinion—shared neither by a majority of my professional colleagues nor of those who influence or interpret the will of the majority of voters, my views may be of little practical interest to you; but you asked me to come and I came and I presented them to you. Thank you very much.

[The prepared statement of Mr. Leontief, together with an attachment, follows:]

PREPARED STATEMENT OF WASSILY LEONTIEF

I have accepted the invitation to take part in these hearings with much hesitation. What I have to say--and what I have said many times before--challenges not only the prevailing public attitude toward these problems in the United States, but also the judgement of a great majority of my professional colleagues.

1. The public seems to accept without demuring, the rapid dismantling of government machinery and the limiting of its functions to those intended by the founding fathers to serve the needs of the simple, agricultural community that this country was two hundred years ago. The professional opinion--except that of a small but very vocal group of libertarian economists--continues to favor economic policies which are supposed to maintain the equilibrium and secure the growth of an increasingly complex and highly vulnerable modern economy through skillful manipulation of a few instruments; such as budgetary deficits or surpluses, selectively adjusted tax rates, interest rates and monetary supply controlled by the Central Bank.

The theoretical justification of the many different varieties of such policies--each representing one of the few basic themes composed of the same five or six different notes--is usually provided in the form of Phillips Curves, Laffer Curves, full employment budgets, rational expectation theorems and other types of more or less complicated theoretical constructs. The factual validation and implementation of these theories is based on what is often referred to as "casual empiricism" or on construction of more and more intricate econometric models. In these models, increasingly ingenious but still utterly unreliable methods of indirect statistical inference are employed in vain to compensate for the lack of hard, systematically organized factual information.

While experimentation with such policies is going on, the performance of the economy is steadily deteriorating. A year ago when President Reagan unveiled his first budget I observed (If Mr. Reagan's Policies Flop, Then What?, New York Times, February 22, 1981) that the proposed combination of drastic tax cuts with unprecedented tightening of credit will very likely bring about a slump threatening to lead into a deep depression. As could have been expected despite all the tax concessions the heralded spurt in productive investment failed to materialize.

Would a refinement of the old, or development of the new theoretical schemes, redefinition of M_1, M_2 or M_{10} that has to be controlled by the Federal Reserve really turn the failure of economic policies, based on present day academic economics, into at least a modest success? Can one really believe that efforts to increase the reliability of econometric forecasts through further refinement of already highly sophisticated statistical procedures or marginal improvements in construction of aggregative indices, that are supposed to pinpoint the day and the hour on which a recession has ended and recovery has set in, would do the trick? I doubt this and so does the American public, for what it seems to approve of in President Reagan's program is not the supply theoretical or monetarist approach intended to provide its rationalization, but rather the enthusiasm with which he proceeded to dismantle governmental organizations that might be capable of implementing active national economic and social policies of any kind.

The captain is dismissing a large part of his crew and has ordered the sails set so that the canvas would catch the full force of the wind, i.e. the pursuit of the highest possible profits. He also has directed the helmsman to take his hand off the tiller so that, unimpeded by an attempt to steer it, the ship could sail in the direction in which the wind happens to propel it. Most passengers seem to be enjoying the beginning of the cruise except, of course, the poor, the old and the sick who are being lowered in leaky dinghys overboard; this, the captain explains, has to be done to lighten the load.

2. But the mood will change, and I think quite soon when everyone hears and feels the rocks scraping the bottom of the vessel. Emergency measures will certainly be taken, but after having been pulled out into deeper water should we resume experimentation with the same kind of policies based on the same kind of theories that permitted the

American economy to reach the stage in which it finds itself today? Let's hope that we will not: the waters that we are about to enter are much more treacherous than those we were navigating up until now. The living space available for our growing and more and more heterogeneous population is slowly but steadily narrowed by the gradual exhaustion of natural resources on one side and on the other side by costly measures that will have to be inevitably taken to arrest progressive environmental degradation.

The inadequacy of the trial and error approach that still dominates the formulation and implementation of our national economic policies will become quite clear when the time comes to meet the full force of the economic and social impact of the rising wave of New Technology.

The interdependence between all different sectors of a national economy is bound to grow with the increase in the complexity of their internal structures and the rise in the scale of operations. Many projects initiated today will come to full fruition only in ten, fifteen or even twenty years from now, and their ultimate success will depend critically on effective coordination with interrelated development in all other branches not only of our economy but also with developments in all other parts of the world. Corporate decision making in this country while effective so far as it goes, cannot afford to reflect a long run point of view; the chief executives lose their jobs if profits sag during three successive quarters. Hence there cannot be coordination in this country between investments and technological developments in different sectors such as is being carried out so effectively in Japan and a few western countries. Over the past ten years American corporations earned an average of eighteen percent on their investments while their Japanese counterparts--only eleven percent. This means that in the United States, corporate management is so cautious that it refuses to move until it can count on recovering newly invested capital in four and a half years. Its counterparts in Japan are prepared to wait for eleven years. No wonder they continue to expand old and construct new plants while large U.S. corporations prefer to maintain liquidity and to diversify their investments by buying up each other's stocks.

3. Much is said about the necessity to compensate investors for high risks they take, but not enough about reducing risks. One and possibly the only effective way of reducing risk--besides taking out insurance that simply redistributes it without diminishing its total level--is systematic coordination based on long range foresight, that is, planning. I use that word although I know that there are some who "reach for the gun" when they hear it.

The planning approach to formulation and implementation of economic policies is less simplistic than the hit and miss approach; it is more ambitious and because of that also more difficult. To put it into practice it is not enough to possess a theoretical understanding of the general principles on which the economic system works. The planning approach requires a rather detailed practical knowledge of the structural characteristics of all sectors of a particular national economy and an accurate assessment of the mutual interrelationships between levels of production and investment in all its branches. Moreover, under a planning approach coordinated policy measures are put into affect not only in response to current difficulties, but often are instituted as anticipative action designed to forestall future troubles. One can not help but think in this connection of our automotive and our steel industries. Whose turn will it be next?

Formulation and implementation of planning policies requires a systematic appraisal of internal and external forces that can be expected to affect the operation of the economy in the future--at least in the foreseeable future; a future which can stretch as far ahead as twenty years and in some instances, such as population growth, much further.

It is not surprising that the general idea of economic planning was advanced much earlier than technical capabilites to implement it became available. The development of governmental statistical services first centering on compilation of national income accounts and culminating in construction of more and more detailed input-output tables paved the way for the creation of the requisite data base. However, it was only with the emergence and the gradual perfection of formal methods for studying intersectoral relationships--which coincided with the development of more and more powerful computers--that placed in the hands of the policymaker the necessary analytical tools. These he can use not only to identify the internal and external changes that can be expected to affect the functioning of each individual sector of the national economy in its relationship to all its other branches, but also to assess in some detail, the direct as well as the less obvious indirect effect of corrective measures that might be proposed.

4. At the present time it is the inability--or occasionally the reluctance of official statistical organizations--to collect and systematize large masses of readily available specialized information, not the lack of analytical tools, that seems to hinder effective practical implementation of the planning as contrasted with the traditional trial and error approach to policy formation in the economic field.

The United States is the only advanced, industrialized country that still does not possess a real, central statistical office responsible for collection, systematic organization and dissemination of facts and figures pertaining to population, natural resources, technology and other aspects of the national economy and society. As things stand now each department and each agency of the Federal and of most local governments compiles data of one sort or another that it happens to need or has needed in the past in connection with the discharge of its administrative or regulative responsibilities. While it collects and publishes more data than any other agency of the government, the Bureau of the Census is not a real central statistical office. Confronted with a giant jigsaw puzzle, economists and statisticians working in the government or private business, as well as those engaged in academic research, spend a large part of their time trying to put its pieces together, that is, to reconcile incompatible figures coming from different sources and to fill as well as they can the gaping holes in the total picture.

What a contrast with the Statistical Organization of Japan or even that of a small country like Norway which has decided recently to discontinue its census because, as it was explained to me, all data needed for government planning, business planning and independent research are collected, systematized and brought up to date continuously, month by month and year by year. The compilation of a decennial U.S. Input-Output Table is assigned to a small team tucked away in one of the many bureaus of the Department of Commerce; its printed version consists of two modest hundred-and-fifty-page-thick paperback pamphlets. The compilation of the most recent Japanese Input-Output Table was carried out by the combined effort of thirteen ministries under the general supervision of a committee of the Counsel of Ministers. The amount of information presented in five hard-cover folio volumes containing the Japanese Table is several times larger than its U.S. counterpart; and it was compiled much faster.

5. Creation and maintenance of a comprehensive data base would permit a drastic reduction in the amount of guesswork, and one might add, of idle theorizing that is involved in our

policymaking process now. But as I said before, providing the requisite data base is not enough. The time has come to take a decisive step by setting up a strong, autonomous research organization analogous to the Congressional Research Services, but more authoritative and much larger, that would provide all branches and agencies of the government with the technical support needed for developing a systematic, coordinated approach to development and practical implementation of national and local, general and sectoral economic policies.

This organization should also be responsible for monitoring in great detail, developments in all parts of the United States economy, with emphasis on changes in their interdependence, and whenever necessary, on changes in the structure of the world economy. It should be able to identify the existing and anticipate the potential trouble spots. The analytical capabilities of this organization should be engaged not so much in futurist prediction but rather in elaboration of alternative scenarios each describing--with emphasis on sectoral and regional detail--the anticipated effect of any particular combination of national, regional and local economic policies. This is, in fact, the only means by which the government and the electorate at large would be enabled to make an informed choice among alternative policy actions.

While providing research support to legislators and administrators responsible for the overall direction of national economic policies, and assisting in the choice of appropriate methods for their practical implementation, the proposed technical organization should be involved in final decision making only to the same limited extent as is, for instance, the Bureau of Labor Statistics in the Department of Labor, or the Bureau of Economic Analysis in the Department of Commerce. To discharge effectively the responsibilities assigned to it, this independent agency should, however, have a decisive voice in determining the direction and scope of the data gathering activities of the Federal and, in some instances, on a consultative basis of state and local governments.

The data gathering and monitoring operations comprising also the formulation of alternative scenarios would eliminate or at least reduce to reasonable proportions one of the most wasteful and futile aspects of the present policy-making process which for want of a better word I call "adversary fact finding." Studying the supposedly factual reports contributed by the interested parties, one cannot help but be reminded of testimonies presented by witnesses summoned by both sides before a judge trying to find out what has actually happened in an automobile accident. The policy-making process would be much more effective if it did not imitate a traffic court but rather were modeled along the lines of a formal arbitration procedure. The arbitrator first establishes the relevant facts and only after does he proceed to explore alternative paths toward a workable agreement.

6. Turning to problems that will have to be tackled in the coming years I would rate the inefficiency of the present policy-making process as problem number one. Mr. Stockman's instructive interview in the Atlantic Monthly testifies to this. So long as that obstacle to their solution is not removed, most of the problems we are facing now will stay with us and at least one very difficult new one will be added. Before turning to it, let me say, however, a few words about inflation, a topic which seems to overshadow, in the public mind, all the others.

Following Mrs. Thatcher's lead, the administration is trying to suppress inflation by beating the entire economy into the ground. There is an old joke about a gypsy who eked out a meager living by renting out the services of a horse he owned. One day he decided to increase the profitability of this enterprise by training the old hag gradually, step by step, to get by on smaller and smaller rations of oats. For a couple of weeks the policy seemed to be succeeding very well until, to the poor chap's great surprise, the horse suddenly died.

Judging by past experience, what reason is there to expect that after inflation has been suppressed, at the cost of prolonged and severe depression, the old hands with their Keynesian or monetarist policies will not be put again in charge, that prices will not again begin to rise and the familiar cycle be repeated?

Inflation that has been plaguing this and most--but notably not all--advanced free market economies can not be suppressed by purely economic measures. While a proper combination of fiscal and monetary policies is indispensable for effective management of a modern economy, their success is predicated not only on tacit mutual understanding, but institutionalized day by day cooperation between business, labor and government.

Austria, a highly industrialized modern democracy, has successfully resisted inflationary pressure by means of such an institutional setup. In the course of annual across-the-board negotiations between trade unions and employers' organizations, the government plays the role of an impartial fact-finder by providing detailed input-output type description of the actual state of the national economy and a systematic analysis of the effects that a proposed settlement will have on its future growth.

To give a specific example: The Institute for Socio-Economic Studies that operates as a branch of the Austrian Academy of Sciences carried out at government's request a detailed analysis of the impact that an introduction of new data processing technologies can be expected to have on the newspaper and all related industries. On the basis of this report, the Federation of Printers, the Federation of Newspaper Editors, and the union of art, media and self-employed professions agreed on the introduction of the Integrated Text Processing System that specified step-by-step how the transition from the old to the new technology should be carried out. The levels of output and employment in various parts of the newspaper and related industries are now changing, but hardships imposed on the employees, the employers and, one might add on consumers, of its product, have been minimized. The negotiations were stiff, but there were no strikes and no lockouts.

The linking of wage restraints with price reductions suggested in the ongoing negotiations between the AWU and GM seems to point in the right direction. However, without an overall agreement between organized labor and organized business extended to all major sectors of the economy within the framework of a carefully designed, comprehensive indicative, i.e. voluntary plan, separate actions of this kind can contribute only little to the solution of inflationary problems. Moreover, let us not forget that Japanese imports, rather than its agreement with the unions, will set the prices at which General Motors will have to sell its cars.

7. Reference to the automobile industry brings me to the new and probably the greatest challenge which not only our economy but also the economies of other advanced countries will have to face in the coming years: the challenge of automation.

The average productivity of labor employed in a telephone exchange (measured by the total number of calls completed, divided by the total number of operators) rises as live operators are replaced by automatic switchboards. When only one operator remains on the job his average productivity becomes very high indeed and it becomes infinite when that last operator is discharged.

All the previous technological revolutions--except possibly that which caused the so called enclosure movement in sixteenth century England when thousands of yeoman farmers were driven off their land--enhanced the commanding role of labor as the dominant, indispensable factor of production. It maintained the demand for it, as compared to the demand for capital and natural resources, and thus secured reasonably full employment for the available labor force at steadily increasing real wages.

From the time the steam engine was invented, successive waves of technological innovation have brought about an explosive growth of total output accompanied by rising per capita consumption and, up until the middle 1940's, a progressive shortening of the normal working day, working week and working year. Although increased leisure (and for that matter cleaner air and purer water) is not included in the official count of goods and services used to measure the gross national product, it has certainly contributed greatly to the well-being of blue-collar workers and salaried employees. At the end of World War II, the situation changed. Successive waves of technological innovation continued to overtake each other as before, and the real-wage rate continued to go up; but the length of the normal work week today is practically the same as it was 35 years ago.

Machinery, however, continues to replace human labor. Some sectors of the economy are more affected by it than others; some types of labor are replaced faster than others. Less-skilled workers, in many instances but not always, go first; skilled workers, later. Computers taking over the jobs of white-collar employees perform first simple, then increasingly complex mental tasks.

While in many operations even dirt-cheap labor could not compete effectively with very powerful or very sophisticated machines, a drastic general wage cut could temporarily arrest the adoption of labor-saving technology. But unless their introduction is interdicted by specially erected barriers, the trend is bound to be resumed. Even a most principled libertarian might hesitate to have the wage level settled by cut-throat competition among workers under continued pressure of steadily improving labor-saving technology.

By controlling the total labor supply, powerful unions can and indeed did maintain wage rates, but as the efficiency of automatic equipment increases and its cost goes down, they will be facing the unenviable choice between continuous wage concessions and increasing chronic unemployment.

Adam and Eve enjoyed--before they were expelled from Paradise--a very high standard of living without working. After expulsion they and their successors were, however, condemned to eke out a miserable existence in heavy toil and trouble, working from dawn to dusk.

The history of technological progress is essentially the story of the human race working its way slowly but steadily back into Paradise. But what would happen if suddenly we found ourselves transported into Eden? With all goods and services produced without work, no one would be gainfully employed and being unemployed under the present institutional arrangement means to receive no wages and, consequently, to have no regular income. Given such conditions, Adam and Eve would have found themselves starving in Paradise.

8. This fable points out the nature of the problem that we and other advanced societies will be facing in years to come. Needless to say, unrestrained, uncontrolled working of the automatic market mechanism can not be relied upon to provide an answer to it. A reasonable response toward incipient technological unemployment brought about by progressive mechanization and automation of all branches of production, transportation, trade and most other service industries should aim at an equitable distribution of gradually shrinking employment opportunities on the one hand and of the gradually increasing national product on the other. This product will continue to rise, however, only if the measures taken to that end will not obstruct directly or indirectly technological advance. Employment policies will have to be combined with income policies.

Income policies I have in mind will be a complex and delicate combination of social and economic measures designed to supplement the income received by the blue and white collar workers for the sale of their services on the labor market, and sometimes even more modest income of independent craftsmen, professionals, and self-employed small entrepreneurs. We are already practicing such income policies by gradually changing the structure of our tax system, Social Security, medical insurance, welfare payments and unemployment benefits. Instead of being curtailed, these sytems will have to be redesigned and expanded so as to reduce the contrast between those who are fully employed, partially employed, retired or simply out of work.

Having heard my observations and recommendations, the honorable members of this Committee will certainly understand the hesitation with which I accepted the invitation to testify today before it. As a minority opinion shared neither by the majority of my professional colleagues nor of those who influence or interpret the will of the majority of voters, my views may be of little practical interest to you.

[From the New York Times, Feb 22, 1981]

If Mr. Reagan's Policies Flop, Then What?

(By Wassily Leontief)

President Reagan has four years to demonstrate that tax cuts, accompanied by a spectacular increase in the military budget, but balanced by sharp reductions in social and other nonmilitary spending, can put the badly listing economy on an even keel. He must prove that the engine of private enterprise, freed from the shackles of environmental laws and other restrictive regulations, will propel it full speed ahead.

Let's hope he succeeds—that the inflation rate falls to 5 percent and the unemployment rate to 4 percent, while the average family's real income will resume what was considered its normal rate of growth: at least 3 percent.

But what if the new policies do not work? What if inflation continues unabated, if unemployment is not substantially cut; and the economy does not resume its prior growth rate? After new elections, the present team of supply-side economists likely will be sent back to their corporate offices, and the old team of Keynesian demand-side experts will be called in with their familiar tool kit of fine-tuning devices to regulate fiscal and monetary policies, and precision gauges to measure full-employment gaps. They might even start by imposing a general price-and-wage freeze that would bring us back to where we were in the fall of 1971.

If the supply-siders fail, not only the politicians but even the general public might finally realize that something is fundamentally wrong with the entire process by which the United States designs, implements, and monitors its national economic policies.

Fundamentally, there can be two approaches to formulation and implementation of national economic policies: A trial-and-error, hit-or-miss approach, or a strategic—corporate management calls it "planning"—approach.

The first consists in putting together a conventional package of policy measures, usually chosen on the basis of theoretical or doctrinal considerations; then introducing another package if the first fails; and if that fails as well, inaugurating a third. Sometimes, however, there is a tendency to stick by the original policy, even if it is obviously not working and threatens to bring the country to economic collapse.

Strategic planning, less simplistic, is more ambitious and thus more complex. To put it into practice, it is not enough to have a theoretical understanding of the principles on which the economic system works and to be possessed by a strong determination to attain certain national goals.

Trial-and-error is bound to fail because policies directed at one particular area—taxation, spending, industry, labor, the environment, foreign trade—will affect not only the areas to which they are addressed, but they are bound to have mostly unintentional and often negative repercussions in all the other fields. A modern economy is a complex body, all parts and functions of which are interdependent.

Strategic planning, on the other hand, is aimed at producing an internally consistent description of different states in which the national economy would find itself after the application of alternatives combinations of economic-policy measures.

Effective implementation of such an approach is hindered by a lack of necessary factual information. The continuous unwillingness of academic economists to give up their traditional reliance on abstract mathematical formulas—linked to reality only by a very fragile bridge of indirect statistical inference—is to a large extent responsible for this. Engaged in constructing elegant theories, they fail to press for creation of a reliable systematically organized data base, which is indispensable for any empirical science.

Creation and maintenance of a comprehensive data base that would permit a marked reduction of the amount of guessing now involved in policymaking is a major task that could be easily carried out by the coordinated efforts of all elements of our statistical establishment. The example of Japan demonstrates that this is not impossible.

Japan is as much ahead of America in compiling the so-called input-output tables describing in detail the structure of national economies as it is in manufacturing efficient cars. The construction of the most recent American input-output table was assigned to a small team in one of the Commerce Department's bureaus. But in Japan, it was carried out by the combined efforts of 13 different ministries under the general supervision of a special Cabinet committee. The amount of detailed information in the Japanese tables is about four times as great as in ours; its compilation took only about half as much time.

Having entered what is proudly called the Information Age, neither the Government nor the private sector can afford to make crucial decisions while groping in the dark. It will take our automobile industry 4 years to tool up to produce an up-to-date car. It will take America at least as much time and effort to close the economic-information gap. Let us not postpone that task any longer.

Representative **Reuss**. Yours has been a great contribution to this committee, and the only point on which I disagree with you is your last statement that your views are of little practical interest to us. They are and will be of intense practical interest to us and I'm most grateful.

We'll hear now from Prof. James Tobin of Yale.

STATEMENT OF JAMES TOBIN, PROFESSOR, YALE UNIVERSITY, AND 1981 NOBEL LAUREATE IN ECONOMICS

Mr. **Tobin**. Thank you, Mr. Chairman. It's an honor to be here at a meeting that has its principle of selection receipt of the Nobel Memorial Prize in Economic Science. It's an honor to be joining such a distinguished team, including Wassily Leontief and Larry Klein, and the others who didn't come today, all of them. I don't think I am any wiser for being in this category than I was before, possibly more foolish because of the distractions of the last few months.

Before I turn to my statement, I would like to second one thing that Wassily Leontief has said—not that I wouldn't second others as well. He referred to the false economies that are taking place in the statistical programs of the Federal Government and in its support of economic research inside the government and, I would add, outside the Government. For an important example, I read the other day that the Labor Department was discontinuing the collection and publication of turnover statistics. Those statistics on layoffs, quits, and new hires are now useful as barometers of the state of the labor market, and they are important for research.

There is another similarity between my statement and Wassily Leontief's and that is our inability to resist the temptation to use a nautical metaphor.

This is the season for reviewing the course of the U.S. ship economy and reconsidering the directions in which its officers are steering it. By general agreement, course corrections are urgently required right now. The captain, his navigators, and the helmsmen are getting plenty of advice from the crew and the passengers, and from other vessels in the convoy, too. But the kibitzers do not agree on the destination. Some want to continue straight ahead on the route to "price level flats," cold and rocky though it may be; they urge the captain to resist the lure of detours and side excursions lest we lose our way. Some are nostalgically preoccupied with reaching once more the comfortable high ground of "long bond island." Others say that if the ship is just steered out of the "red sea" into the "straits and narrows of black ink," all other desirable destinations will be easily within reach. A few speak up for "full recovery mountain," beyond which stretch the gently rising "plateaus of stable growth." The mountain is a once fashionable landmark that has been receding from view for so long it is almost forgotten.

Block that metaphor, the New Yorker used to say. Now that the hopeful assurances of a year ago that all destinations could be easily and quickly reached simultaneously have been revealed to be costly illusions, Federal policymakers have the opportunity and responsibility to plot a new macroeconomic course. This committee, as a statutory guardian of the goals of the Employment Act of 1946, has particular responsibility for seeing that, wherever else the new course leads, it will in the end promote, in the words of the act, "maximum employment, production, and purchasing power." Realistically, there is a good chance that we have already seen the lowest unemployment rate of the first half decade of the 1980's or of this Presidential term. The dismal trend by which each business cycle peaks at a higher unemployment rate than the preceding one, by which the 6- and 7-percent rates that used to characterize troughs are no longer attained in recoveries, must be arrested and reversed. Otherwise, even balancing the budget, stabilizing the bond market, and bringing inflation down to low single digits, will in the end be hollow and fragile triumphs.

I shall argue for a new mixture of macroeconomic policies: An easier monetary policy, with real interest rates low enough to promote full recovery from this recession and the preceding one that we never have recovered from; a tighter prospective fiscal policy so that Federal deficits do not divert saving from capital formation in prosperous times; a wage-price or incomes policy designed to maintain progress toward disinflation during recovery. I'm going to use incomes policy in that sense and not in the broader important sense that Professor Leontief referred to at the end of his statement.

The age of stagflation in the United States has been punctuated by four recessions, each a deliberately intended consequence of anti-inflationary monetary policies. The current recession followed hard on the heels of the incomplete recovery from the third, the recession of 1980. The economy stalled in 1981 when the recovery collided with Federal Reserve restrictions on monetary growth. The collision took real—that is, inflation-corrected—interest rates to record highs, a record since the Great Depression, devastating not only to interest-sensitive demands for housing, cars, and other consumer durables but eventually to business investment in plant, equipment, and inventories. The experience should lay to rest the conclusions some observers drew from the 1980 downturn; namely, that high interest rates could not cool off the economy without credit controls. Now we have seen that prosperity, even on the bleak scale of last spring, cannot survive 6, 8, 10 percent of real interest rates and the high cost of equity capital they bring about.

There is one similarity, nonetheless, of the onset of the present recession to that of the previous one and also to that of the one before, in 1974. Each time the physicians of the Fed, frustrated by the apparent robust resistance of the patient to the bitter medicine they were administering, stepped up the dosage and produced a sharper and deeper recession than presumably intended. Last year this took the form of below-limit monetarism. I mean by that the Federal Reserve aimed not just at the lower limit of the M_{1B} target but actually below that.

Rebound from the current recession during this calendar year, as generally forecast, is probable because of the normal cyclical rhythm of inventory liquidation and rebuilding. Moreover, the Congress has adventitiously provided a fairly well-tuned countercyclical fiscal policy, the first two installments of the 1981 personal income tax cuts. You could improve that by moving the date of the second installment from July 1 to January 1, 1982. The 1982 fiscal year budget is lost anyway.

Unfortunately, the prospect is that the 1982 recovery too will collide with the monetary barrier. As credit demands revive during recovery—to finance inventory restocking and renewed demands for houses, durables, and fixed capital, they will outrun the bank reserves the Fed is willing to supply. The result will be another runup of interest rates; again I mean real rates, computed after allowance for expectations of inflation. The collision is likely to stall the recovery even farther from maturity than in 1981. Chairman Volcker has made the Fed's program quite clear. It is to reduce monetary growth gradually but firmly year after year, regardless of what is happening to the real economy of jobs and production, until monetary growth is consistent with sustainable real growth of the economy with no inflation. For 1982 the Fed starts from a low base in fourth quarter 1981, perpetuating the underfulfillment of its M_{1B} target for the preceding year. Moreover, interest rates are right now at extraordinarily high levels for this phase of a business cycle.

Unlike Larry Klein, I do not have a forecasting model; and I am not predicting another recession in 1982. I don't know how fast or how long the recovery will be; the recession phase isn't over yet. We could see, after an abortive recovery, a longer period of slow growth or flat performance than occurred between this recession and its predecessor. What I do not see is the foundation for a sustained recovery in 1982–83 that will absorb the extra slack in the economy resulting from the last two cycles.

Given the Fed's intentions, the only development that could make the outlook brighter is a rapid decline in the rate of inflation. This could make the Fed's monetary targets compatible with more real growth in economic activity at lower interest rates—provided the Fed did not exploit an inflation lull once again by lowering their targets or shooting below them, a temptation that will appeal to them until they are sure they have permanently triumphed over inflation. In 1982 progress in disinflation depends mainly on reducing wage inflation. Already in 1981 we got all the help we can expect from external prices, because of the oil glut and the appreciation of the dollar against foreign currencies, and from domestic prices not closely connected to wages, food and raw materials. Wage inflation began to subside, as one would expect in periods of recession, high unemployment, and actual or imminent bankruptcies. It will subside further this year, especially in the disaster areas of the economy. To what extent soft settlements in automobiles and steel will set patterns that others follow remains to be seen; it will be an interesting year for students of wage determination. My guess is that there will be further modest progress in disinflation, but not enough to keep the Fed's targets and policies from barring the way to real prosperity.

The monetary navigators are piloting the ship these days. After all the rhetoric of 1981 the Federal Government's only anti-inflation program is the same as Mrs. Thatcher's in England, the same old remedy that previous administrations have intermittently tried. This is to depress monetary spending for goods and services and let competition of workers desperate for jobs and employers desperate for customers lower wage and price inflation rates. President Reagan and his three predecessors all swore not to use unemployment as a remedy for inflation. Every one of them has done so, and encountered the same difficulties. The process is slow and painful. The difference this time is not in the stance of the President, who is not Mrs. Thatcher, but in the determination of the Federal Reserve Chairman, who is trying to play the economic role of Mrs. Thatcher without the political clout and public rostrum of a head of government. Some economic theorists strongly believe that if the government's determination is understood by workers, unions, and business managers, disinflation will occur more rapidly than in the past and cause less transitional damage. If they know that no countercyclical expansionary forces will bail them out, they will bite the bullet and lower their wages and prices to save their jobs and markets. There is some logic in the position. But despite the clarity and publicity of Mrs. Thatcher's threats, the process has been very slow and very costly in her country. In the United States the threats, coming as they do from Chairman Volcker rather than the President, are muted and therefore less effective.

I have long advocated an incomes policy to shorten and to eliminate or diminish the overall economic cost of disinflation. A schedule of gradually declining guideposts for wage increases, together with a guidepost limiting percentage markups, would be more effective than unassisted monetary disinflation and harmless to employment and production. Such a policy requires Presidential leadership to build a consensus of support from labor and business. For that the ideal time was a year ago, but it is never too late. The recession itself offers some opportunities, especially at this time of agonizing reappraisal. Since there is now excess slack in the economy by anyone's reckoning, the administration and the Fed are in a position to offer labor and business a more expansionary macroeconomic policy package, including relief from high interest rates, in return for their support of guideposts. Alfred Kahn recently argued persuasively for a strategy of disinflation that relies on social consensus and the rewards of prosperity rather than on threats and the penalties of depression.

For individual groups of workers and their employers, a tax-based incomes policy would reward compliance with the guideposts by tax credits or rebates, perhaps scaled to payroll taxes. But flexibility would be preserved. Those firms which for local or sectoral reasons would not find it worthwhile—for example, expanding industries that need to bid for labor—would not be compelled to comply but would forgo the rewards. In any reconsideration of the Federal tax system—and I hope Congress will correct this session some of the hasty mistakes of last year—room should be found for tax incentives for disinflation. The sin tax increases now under discussion as a way to enhance revenues are price increasing rather than inflation-reducing.

There is broad agreement that an important ingredient of any recipe for the future health of the American economy is capital formation. To increase national saving and investment was a principal rationale for the 1981 tax legislation. Yet this season's reappraisal reflects fear that the budget deficits resulting from the legislation will crowd out private investments, and the deficits in prospect for fiscal years 1982, 1983, and 1984 are blamed for today's high interest rates. The next step of tortured logic is another turn of the screw on the defenseless dependents of social welfare programs and on the State and local governments invited to cope with the problems with smaller Federal funds and with their own finances devastated by recession.

No macroeconomic subject generates more confusion than "crowding out," and none is in greater need of straight thinking. The scenario sketched in the previous paragraph leaves the Fed aside, as if it were a passive innocent actor in no way responsible for the high real interest rates that inhibit capital formation. Yet Fed policies and the interest rates they brought about "crowded out" investment, and saving too. Moreover, they would be a barrier to real growth and full recovery whether expansion were fueled by buoyant private demands with Government budgets in surplus or by tax cuts and Government spending for defense or welfare. As explained above, Fed monetary targets just do not provide enough money to finance a fully prosperous economy.

The mechanism of monetary "crowding out" is a familiar one. When interest-sensitive investments are discouraged, workers lose jobs and wages, businesses lose sales and profits, governments lose revenues but acquire new spending obligations. They all save less or dissave more. The Federal deficit is higher—witness the sudden drastic upward revisions of the estimates once the administration acknowledged the recession. To regard such deficits as the causes of high interest rates and low private investments is about as reasonable as to blame police and rescue vehicles for highway accidents because they are invariably observed on the scene.

Many tears have been shed, many hands have been wrung, about the low propensity to save of American households and the high propensity to dissave of their central government. But in these days of stagflation, frequent recessions, and stunted recoveries, the Nation's thriftiness is not the effective constraint on its accumulation of capital. Labor, plant capacity, and other resources are available for greater capital investment without curtailing anybody's consumption or any Government purchases. The scarcity that prevents investment from expanding and carrying income employment, and saving in its train is the scarcity of money and credit, man-made in Washington, D.C. That scarcity, only that scarcity, dictates that one economic activity can expand only if others contract. Suppose households and governments became more thrifty—the path to lower interest rates urged by so many pundits. Would an increase in their propensity to save translate into greater national investment? Not necessarily, not automatically, not without active cooperation by the Fed. Unless the Fed were to become more expansionary in these circumstances, income and employment would fall and some of the potential increment of savings would not be realized but would be wasted in unemployment.

Projections now indicate that in 1984 and thereafter Federal deficits will be, in the absence of new actions on expenditures and taxes, around 2 percent of GNP even when and if the economy is operating much closer to its feasible potential. Predictions are higher for the size of the deficit relative to GNP if the economy does not recover fully, but 2 percent is not high compared to other countries and it's not an economic and financial disaster, but it would be better if that 2 percent of GNP were going into capital formation. Raising taxes to reduce private consumption or cutting public consumption is necessary to make that happen. But it is by no means sufficient. Monetary policy must simultaneously assure that interest rates will be low enough to induce investment big enough to absorb all the Nation's high employment saving.

I believe myself that the resulting policy mix (tight budget, easy money) would be preferable to what we have in prospect (easy budget, tight money). But it won't just happen. It won't come about just by congressional repair of the budget while the Fed sits tight. A tight fiscal, tight monetary combination is not the solution. There is no point in diminishing Government claims on high employment saving unless we are going to have high employment and the saving is going to be elsewhere employed. It will take deliberate and explicit agreement among President, Congress, and Federal Reserve to get the right policy mix.

Finally, I want to warn against an overly narrow and doctrinaire conception of what capital formation is and who does it. Is America overconsuming? Are the currently living generations making inadequate provision for their children and descendants? How can we best fulfill our obligations to the future? Concerns of these kinds underlie contemporary moves to stimulate saving and investment—and to the extent that these moves have rationales beyond the self-interest of savers and investors. Provisions for the future take many forms. Accumulation of plant and equipment by private business is an important one, but not the only way. We need robots and computers, to be sure; maybe we need casinos and ski lifts. We also need schools, roads, reservoirs, sewers, and parks. We need to preserve and protect our air, water, land, and nature. We need to educate our children and youth and equip them to be productive workers and citizens. Substitution of private business physical investment for public investment in human capital, in environmental protection, and in essential civic services is misguided. The Congress should not believe it has discharged its obligations to the future by freeing financial saving and business investment from taxation.

Thank you.

Representative Reuss. Thank you, Mr. Tobin. Mr. Klein, welcome, and would you proceed with your statement.

STATEMENT OF LAWRENCE R. KLEIN, PROFESSOR, UNIVERSITY OF PENNSYLVANIA, AND 1980 NOBEL LAUREATE IN ECONOMICS

Mr. Klein. Thank you, Mr. Chairman. I want to apologize for coming late. There was a small train accident.

First, I want to assess the present state of the economy and start by saying that what I have heard so far from my colleagues leaves us, I believe, in rather good agreement at this table.

During the past year there has been a significant worsening of the economic environment, not in every dimension but to such an extent that the overall appraisal must conclude that we, as a nation, have gotten ourselves into a serious economic predicament. The year 1981 started out on a decidedly positive note. The recovery from the 1980 recession was proceeding vigorously. The first quarter's growth was very strong, and although the rate was unsustainable, it clearly posed the problem for 1981: How to maintain the recovery pattern along a noninflationary path? The response to that challenge has clearly been a failure.

At the beginning of 1981 growth was, as noted already, strongly positive; unemployment was holding to a steady pattern under 7.5 percent; the dollar was strong; interest rates were easing slightly; and the first signs of weakening oil prices, grain prices, and other basic material prices were showing the effects of excess supply. This was a major factor in contributing to a lessening of inflationary pressure.

The general economic environment was extremely favorable and moving in a positive direction. What went wrong with the management of economic policy to throw the economy into a renewed recession after just about 1 year, following the previous upper turning point? A combination of overreaction by monetary authorities in pursuing policies of tight credit, and serious miscalculation of accompanying fiscal policies by the administration led to a complete breakdown of credibility vis-a-vis financial markets. The unusually high interest rates set back home buying, car purchasing, and other credit-based expenditures. In general, aggregate demand was weakened by the loss of confidence in national economic policy.

Early in the year, I and other econometric forecasters pointed out that the wide ranging tax cuts, together with increases in military expenditures and nonmilitary reductions added up to deficits that would soon be in the neighborhood of $100 billion. The corresponding figures of the administration that led to the misleading projection of budget balance were based on an incorrect assessment of the pace of economic activity, the level of unemployment, and the prevailing rate of interest. There was no allowance for cyclical recession over an entire 4-year period, yet the recession was upon us by July, according to the dating by the National Bureau of Economic Research.

There is presently a far more reasonable assessment of economic prospects and likely deficits than at any time during the formulation of policy in early 1981, but the present reassessment calls for restructuring of policy, and this gives an unfortunate impression of volatility, instability, and uncertain targets. One of the greatest criticisms of economic policy of previous administrations has been lack of stability. The present administration is off to a shaky start, for the seemingly well laid plans of 1981 have now to be significantly reconsidered, only 1 year later, in order to guide proposals that come up against rising deficits—not deficits falling nicely toward zero.

The recession in production, the sharp rises in unemployment, the gyrations of interest rates, the devastation of activity in key sectors (steel, motors, housing) of the economy are all negative factors in the present situation. There are, fortunately, some positive factors. The rate of inflation has decelerated. It has been helped along by declines in food, fuel and other basic material prices, but it is also being brought down by the trend toward lower wage rate increases. Rising unemployment is difficult to accept, but it is now having an impact on wage costs, which will soon be reflected in restraint of inflation. Interest rates have receded from their 1981 high values. It remains to be seen whether these reductions will be long lasting, and that issue is this year's challenge to policymakers to present a credible program to credit markets and the public at large.

The problems of our economy are not confined to our own shores or boundaries. The same policies and market consequences that led during 1981 to a new round of recession with rising unemployment also had serious repercussions on our close partners, indeed on the whole world economy. Canada is being pulled into recession by our own misfortunes. That is plainly visible. Western European countries, locked into recession already in 1981, were prevented from using stimulative monetary policies to revive their own investment performance and durable goods industries. Our high interest rates forced them to refrain from seeking lower rates, for, to have done so, would have provoked capital flight toward dollar assets. This would have led to exchange depreciation that would have made the problem of inflation control all the more difficult. High interest rates and high exchange values for the dollar have also impaired our own export performance to the point of shifting our favorable balance on current account toward deficit. Our aim should be to try to stabilize the American current account balance and the exchange value of the dollar. Given the key role of our currency in world trade, our partners want, justifiably, a steady dollar. Our doctrinaire monetary policies make for interest rate and exchange rate volatility—not stability.

THE OUTLOOK

Where is the recession leading us? The chances are good that recovery will set in before mid-year 1982. Even though economic activity might begin to pick up during the early part of this year, the recovery is expected to be quite mild; therefore, the full year 1982 will be hardly better, if at all, than the recession year performance of 1981. The next year, 1983, should be a recovery year, from beginning to end, but the recovery process is expected to be weaker than in previous such cycle phases, and the end result will be poor rates of capacity utilization and little contribution, if any, to the reduction of unemployment.

In this slow economy, as it is projected, we can look forward to a continued easing of inflationary pressure, together with falling interest rates. The most depressed sectors of the economy should turn from decline to gain. This is welcome news for the housing and automobile industries, but the projected recovery lacks the needed strength to return these areas to strong performance based on historical records. A good housing year would call for 2 million starts; whereas the current outlook is for about 1.5 million by 1983. Similarly, car sales should reach only about 10.5 million units, which falls short of a previous high of about 11.5 million

One of the most controversial aspects of the recovery is the position of interest rates. A continuing downward trend in short-term rates for the next year would be favorable for recovery. A fear exists, quite justifiably, that fiscal policy, beset with two more major installments for income tax cuts and large increases in military outlays, will lead to large deficits, in excess of $100 billion. To finance these large public deficits by selling interest bearing securities in the face of continued monetary stringency and large private sector credit needs, will mean the bidding up of interest rates once again, choking off recovery once again. That set of contingencies is not in my baseline projection, yet it cannot be dismissed out of hand. The economic policy mistakes of 1981 can be repeated again. That is the reason for entertaining the fear of the contingency scenario.

It appears that very modest turns into recovery have taken place recently in the United Kingdom and France. Those are good signs, but the unemployment outlooks are not very bright. Western Europe, as a whole, is still looking for more definite recovery signs. I expect that they may soon come from the side of restocking, in spite of the adverse effects of our own recession. Therefore, the outlook is for moderate industrial recovery to take place on a broad scale during 1982, but the full year's results will be only barely visible. More positive signs should be visible in 1983.

ECONOMIC POLICY

Now I want to turn to economic policy. Apart from asking that policy be stable, credible, and internally consistent, what are some explicit measures that should be considered for the next couple of years? First, fiscal calculations must restore some order to the budget. New revenue increments or expenditure cuts are needed. More revenues can be found by reconsidering the proposed tax cut for July 1983. That tax reduction should be moderated.

Increases in indirect taxes are to be avoided where possible because they raise prices, just at a time when we are looking for moderation of inflationary tendencies. Selective expenditure increases should also be considered, apart from their immediate adverse impact on the deficit, because some of them can be highly beneficial to productivity and long run contributions to inflation restraint. I have in mind particularly a full restoration and increment of support for basic scientific research and R. & D. This is the stuff out of which future productivity gains are to be made.

Monetary policy has been overly restrictive and one sided. It should be directed away from undue reliance on attempted control of money aggregates toward a more balanced view of policy targets that include interest and foreign exchange rates too. Our success in achieving existing monetary targets has been quite limited and has generated destabilizing swings in interest rates. A policy of internationally coordinated interest rates reduction could do much good for the world economy. If several major countries were to try to bring down rates simultaneously, there would be limited impact on international capital flows and no perverse side effects on exchange rates. At the same time, the improved rate of return to capital investment would benefit short-run activity in capital formation and, within the medium term of 2 or 3 years, contribute significantly to better productivity gains. This would be healthy for our economy and the whole Western Alliance.

A complete program of economic policy needs development along many technical lines of public decisionmaking. In this presentation only broad outlines of policy changes can be indicated, but they would consist of such things as:

One, redirection of tax policy from stimuli to consumer spending toward more emphasis on investment stimuli.

Two, a focus of attention on youth employment, coupled with a more serious effort for on-the-job training.

Three, more vigorous expansion of exports, with a view toward maintaining a strong enough current account balance that would make for dollar stability.

Domestic policy should aim for enhancement of productivity growth while international policy should aim for dollar stability. Naturally, good international performance will require that the United States demonstrate that we are competitive on a world scale, and productivity growth will contribute much toward this end.

Both of the previous speakers have addressed considerable attention to the issue of incomes policy and I didn't include that specifically in the range of issues that I considered in my statement, though I fully agree that incomes policies have great potential for helping us in this stagflation situation. I do believe that the climate is hostile or unfavorable to incomes policy. That is no reason for our shying away from careful consideration and development of it and asking for it, but I believe also that a great deal of attention toward a larger series of interrelated structural policies of the sort that I outlined may give us the benefits that we need, and we may be able to make a better economy without an incomes policy.

However, I think at the present time that a great deal of debate and attention should be devoted to incomes policies so that we have something strategic to rely on in case our problems remain with us. Thank you.

ECONOMIC POLICY COORDINATION

Representative REUSS. Thank you, Professor Klein.

Starting with one of the many interesting points that were made in your statement, Mr. Klein, you say this: "A policy of internationally coordinated interest rate reductions could do much good for the world economy." I completely agree with you.

Let's try to translate that into practical terms. Suppose tomorrow President Reagan would make a statement, or perhaps it could be done in the state of the Union message a week from tomorrow, along these lines: Just like everybody else in this country, he's done a few things that were misguided and now he thinks that the industrialized democracies would be much better off with a lower interest rate structure, that the high interest rate structure is creating joblessness in unnecessary amounts through the world; that specifically the President is going to withdraw the order he made to the Federal Reserve in his economic program of February 1981 which said, "Come hell or high water, no matter what the consequences, reduce the money supply year after year," and he's going to call a halt to that further tightening at least until the world makes sure that recession doesn't evolve into a depression; and that it is his intention, just as soon as we look as if we're getting out of the current recession, to remove some of the excesses of his tax program which are huge budget busters and some of the haste and excesses of his military buildup, and with his American leadership he invites the Germans, the Japanese, the French, and the Italians, and the Low Countries and the Scandinavians to coordinate their economic policies.

Would that not be a good thing from the standpoint of the wellbeing of the democracies, and might it not do something to curb the present rather sour view of the alliance? I think that's what you were saying, but I wanted to spell it out in more practical terms.

Mr. KLEIN. Well, I think you have stated it probably better than I have. I want to say that there is almost a knee-jerk reaction on the part of many monetary authorities that any reduction in interest rates or any move toward monetary ease is automatically inflationary.

I think in the present circumstances and particularly if coordinated so that we don't get the perverse exchange rate movements, that it need not be inflationary and I think there are some parts to the calculation that would make it anti-inflationary.

In the short run it would remove the high interest component from the price indexes. It's unusually present in our own but still present in any consumer price index to a certain degree. And insofar as it stimulates capital formation it will contribute to higher productivity in the near term, and, in addition, the cyclical gains in productivity in the immediate future would appear.

So I think on many facets we could argue that this kind of coordinated policy would indeed be an anti-inflationary policy.

INTEREST RATE POLICY

Representative **Reuss**. I may say to Mr. Leontief and Mr. Tobin that I have made many notes to their testimony and will get to them, but somehow I'm working my way backward through Mr. Klein who was the most recent witness.

Let me ask just briefly at this point, Mr. Leontief and Mr. Tobin, if you were a Senator or Congressman and you were in the House Chamber next Tuesday night for the State of the Union message and the President did make such a turnabout declaration on high interest rate policies—not only for us but for the industrialized democratic world—would you applaud, boo, or remain impassive?

Mr. **Tobin**. I would applaud very much, Congressman Reuss. I think the correction of the fiscal program would be a part of the package that would be essential for domestic reasons—confidence in the capital markets. It could take the form of suspending the third installment, the 1983 installment, of the personal income tax reduction and the bracket indexing until a later time when the circumstances, fiscal and economic, would be more favorable to it. Perhaps also it would be wise to interrupt the phasing in of some of the business tax reduction too at the same time.

The opportunity should be used not simply for reducing the general level of world interest rates. Ours need to be reduced a little bit more than others because the rates are out of line, and that has led to appreciation of the dollar beyond what can be justified by purchasing power parity. The value of the dollar handicapped our exports, and high world interest rates are handicapping, as Larry Klein said, the recovery efforts of other countries.

Representative **Reuss**. Professor Leontief, in general, would such a change in policies be good?

Mr. **Leontief**. Yes, I would applaud in a perfunctory way, but yes, I would applaud. I simply note my support for my colleagues. My feeling is that it would not solve our problems. I think it will simply lead to the same kind of, as I call it, a trial and error approach. Possibly they could help to alleviate some of the immediate difficulties, but I don't think it could bring about a solution of our basic problems.

INFLATION AND EXCISE TAXES

Representative **Reuss**. Thank you. Let me turn now to another statement made by Mr. Klein and I think a similar statement was made by Mr. Tobin. I quote from Mr. Klein's statement: "Increases in indirect taxes are to be avoided where possible because they raise prices just at a time when we are looking for moderation of inflationary tendencies."

I think that's a valid statement. Just take the proposed taxes which we hear are being considered—the tax increases on beer and wine. Those are sometimes referred to as sin taxes. But it's a fact, is it not, that increasing the tax on those commodities would be inflationary? Is that not so?

Mr. **Klein**. Yes. I don't think it would be permanently inflationary, but the immediate impact would be. One of the interesting aspects that really lies behind that is the issue of trying to draw a parallel between President Reagan's program and Mrs. Thatcher's program because most of my British colleagues who look at economic policy in a way that's similar to my own think that the primary mistake of the first year of Mrs. Thatcher's program was to have a significant increase in the value-added tax. That postponed bringing down inflation for a whole year and meant that the work on the side of unemployment and recession had to be all the more serious. In the second year there was some improvement toward inflation, but then indirect taxes went up again and now they have lost the advantage and gone from single-digit back to double-digit inflation—low double digit, but nevertheless double digit. The argument has frequently been made in this country that Mrs. Thatcher did it all wrong and that our program is distinctly different. In most of its dimensions it is getting to look very much like the British program and the main distinction has been this treatment of indirect taxes. But indirect taxes are in the consumer price indexes and other indexes, so an increase in indirect taxes will be an increase in the index and will stay in year over year comparisons for 12 months, for a given step. That is the sense in which it's inflationary because we're looking month by month for indications that the rate of inflation has dropped, and this would suddenly turn the situation around.

Representative **Reuss**. Mr. Leontief, did you want to comment on this less than cosmic point?

Mr. **Leontief**. My feeling is that since the taxation system changes slowly to pay attention mainly to the short-run effect of the changes in the tax laws is not enough. I completely agree because I think it's a fact with the observation, but if you introduce sales taxes, obviously for a while you increase the price level, but you don't increase the rate of inflation in the long run. So far as our tax system in general is concerned, it is related to the whole problem of incomes policy. We introduced progressive income taxes many years ago in order to introduce certain justice in our economic system. Progressive income taxation under which the rich contribute a relatively larger fraction of their income than the poor was the only way at that time in which the Government could affect the income distribution in favor of the less privileged.

Now the situation is quite different. We can use the expenditure side of the Federal budget—the social security, unemployment relief, medicare and other social programs—to shift some of the economic burden from the upper to the lower income groups. On the other hand, income taxes, particularly progressive income taxes, put a terrific burden on the conscience of individuals and of the legislators who are pressed to provide all kinds of loopholes. As a matter of fact, just now we did change the structure of the income taxes in favor of the rich.

For this reason I favor a value added tax of some other kind, an indirect taxation whose burden, let me say, people don't notice. We don't sweat it out on April 15 because it's taken out in a rather automatic way, and I prefer, if somebody skins me, at least it will be with anesthesia.

On the other hand, this will I think give Government very steady revenues and enable the Government to begin to have real income policies, to have funds, for example, to refinance social security, medicare and so on. So I'm in favor of taking it easier on personal income taxes. I'd rather have taxes which are much easier to collect, which are all kinds of sales taxes, value added taxes and so on. This is my opinion.

ECONOMIC RECOVERY

Representative **Reuss**. Thank you.

Mr. Klein, in your outlook you say—here I'm quoting the more optimistic words you used—"The chances are good that recovery will set in before midyear 1982," and then you go on to say, "The next year, 1983, should be a recovery year," all of which sounds fairly joyous; but then you go on to say that a fear exists quite rightfully that fiscal policy, mainly tax cuts and military increases, will lead to large deficits and these, combined with continued monetary stringency, will mean the bidding up of interest rates once again choking off recovery once again."

Well, I hate to be a dispenser of gloom, but why isn't that a very real possibility which would vitiate the recovery you see and lead instead to stop-start, off again, on again stagnation?

Mr. **Klein**. Well, you have to appreciate that I'm a professional forecaster and whenever we make forecasts traditionally we make a central projection or what I call a baseline projection, and then say what are upside or downside contingencies. I see this as one of the contingencies that would be on the upside on interest rates or on the downside on activity levels.

I really do believe in the baseline projection that recovery process will start. It is not a terribly strong recovery, particularly given the fact that when we are in a depressed state the initial thrust upward should be relatively rapid, in excess of long-term growth rates. The recovery that is being projected in this baseline case, is only about equal to medium-term or long-term growth rates. It is not large enough to make a very significant contribution to reducing unemployment.

Now the possibility of high rates exists—and I would say that has a lower probability than the baseline case—but I really believe in my baseline case--and we must always try to do this in outguessing monetary authorities—that there will be some easing of monetary pressure and we won't have a repeat of 1981 with astronomical interest rates.

So the baseline projection has some accommodation involved and a continued soft downward movement in short-term interest rates that helps this recovery and doesn't choke it off.

FEDERAL RESERVE TARGETS

Representative **Reuss**. Well, that is very significant and helpful. Then you predict stagnation plus a little upturn if, and only if, (1) President Reagan junks his February 1981 economic recovery program's monetary policy which mandated the Fed to keep lowering its targets; and (2) if the March of Dimes syndrome on the part of the Federal Reserve vanishes. By way of explanation, we called the polio fund raising program the March of Dimes. For years, even after polio had been banished from the land, we kept right on with the March of Dimes. That is comparable to the Federal Reserve which, even though inflation—thanks to the Arabs and thanks to the good crop year and thanks to cheap imports due to a hyped-up dollar and thanks to some wage abstinence on the part of labor—even though inflation is down, the Fed only a week or two ago actually lowered its monetary targets from 3.5 percent base to 2.5 percent base. You envisage that they would recant and say, "We were wrong and we're not going to lower the targets."

It seems to me they could recant and I hope they do. And I hope the administration does, but it would seem to me that you can't achieve this nondisastrous economic projection unless they do.

Mr. KLEIN. No, I can't squeeze it out, but I'm rather pessimistic that the Federal Reserve can actually hit their targets and I don't believe that there's been success since October 1979 in operating the new rules and hitting the targets. I don't believe the targets were successfully hit in 1981, and I don't believe that one should look only at a single monetary aggregate. There are several. The Federal Reserve will do what it can on the things that it directly influences; namely, the supply of reserves to the banking system, but it depends on the outcome of the economy as to the actual achievement of rates of growth for each of the various "M's".

Mr. TOBIN. Could I comment?

Representative REUSS. Yes, Mr. Tobin.

Mr. TOBIN. First, in regard just to the narrow technical matter of the Federal Reserve's targets, the change in definitions and the fiddling around with corrections and noncorrections for the new M_1 compared with the old M_{1B} and the old M_{1A} and corrected M_{1B}—confuse the picture so much that the Federal Reserve has some room for manuever without destroying its credibility. It is unfortunate that the Fed has locked itself into these elusive and not very meaningful concepts of the money stock.

I think probably the Federal Reserve has a deeper policy than just hitting these technical target brackets. It is to reduce the rate of growth of dollar spending in the economy from year to year. Well, that used to be running around 11 or 12 percent a year. They would like to get it down to 10 or 9 and lower gradually as part of their anti-inflationary crusade. If it turns out that, because of financial innovations and other changes in velocity of circulation of whatever monetary aggregate they happen to be focusing on at the moment, those targets mean more or less than expected when they are actually translated into spending of money for goods and services, then I think they will adjust.

What we need to change is their Thatcher-like determination——

Representative REUSS. Their what?

Mr. TOBIN. What needs to be changed is not some 2.5 to 5 percent target for any particular monetary aggregate. What needs to be changed is a more fundamental stance of policy, the Thatcher-like stance of policy. This stance is that regardless of what happens to the economy, regardless of what unemployment rates are, regardless of what the prospects for real economic recovery are, they will just keep on doing the same thing—in reality not just in appearance. So that's point No. 1.

Point No. 2, I wanted to make is about the effect on the economy of raising taxes or foregoing now scheduled tax increases or cutting Government expenditures, tightening fiscal policy. Now somehow we've been talking ourselves into the view that deficits in the budget are inflationary, raise interest rates, and lower economic activity, employment and production, all at the same time. I don't think that makes too much sense.

The problem with the deficits in 1983 and 1984 is not that we would have stronger years of recovery if there were a tighter policy, if taxes were raised or expenditures were cut. Spending money for defense stimulates the economy and cutting taxes and letting people spend the money stimulates the economy too. The question whether it overstimulates or not, that depends on how strong the recovery is and what the monetary authorities do. But I don't quite follow the logic which says that in order to make a stronger recovery in 1983 and 1984 we should raise taxes and cut expenditures and cut down the size of the budget.

Now it seems to me what we need to have, whatever the budget is—what we need to do to have a stronger recovery in 1983 and 1984 is to have an easier monetary policy. If it's enough easier we will be able to have a tighter budget policy too—and that may be what we would need to do in order to keep the economy from being overstimulated. It is certainly what we would like to do in order to divert saving which might otherwise be absorbed in Government deficits into capital formation. But I think the reason that there's alarm about 1983 and 1984 is the prospect of high interest rates and the perception that given the Federal Reserve's policy, large deficits will make the Federal Reserve firmer in following its policy. But I think we ought to be clear that cutting future deficits like that isn't by itself alone going to make the economy stronger.

MONETARY POLICY

Representative **Reuss**. On your first point, the monetary point, suppose—and no one could be more delighted than I if this came to pass—that tomorrow you found yourself as Chairman of the Board of Governors of the Federal Reserve System.

Mr. **Tobin**. You're the only person in the world that would be delighted.

Representative **Reuss**. Oh, I think I could produce a small clique. But at any rate, suppose that happened and you were so ill advised to accept. Am I right in thinking that you, taking cognizance of the fact that our industrial capacity is only operating at 73 percent, and that there are at least 9 million unemployed, perhaps 12 million or whatever, am I right in thinking that you would ease monetary policy, create new money at a pace somewhat less austere than the pace of 1981, that you would keep an eye on interest rates and consciously try to bring them down, but that you would not, by becoming Chairman of the Fed, relieve yourself of the disagreeable little task of defining and refining M_1, M_2 and all the aggregates. While someone shouldn't make a fetish of them, nevertheless, they are handy to have before one on the charts that are displayed to the Open Market Committee—and if you're going to do that you have to try to define them and refine them.

Mr. **Tobin**. I would publish the statistics, certainly. I'm in favor of publishing lots of statistics and people can do with them what they want. But I would not state the targets of the Federal Reserve operations for year to year or quarter to quarter in those terms and I certainly would not do so in a way that ties the Federal Reserve's hands to statistics and marksmanship in hitting targets that don't mean an awful lot and mean different things at different times. I certainly would not do that.

If there were going to be targets for Federal Reserve policy from year to year that were stated, I would prefer that they be stated in terms of the total increase in dollar value of national product, dollar spending on goods and services, which is any old money stock you want to take times its velocity, whatever that might be, rather than the money stock by itself. So I don't believe any good has come out of expressing Federal Reserve policy targets in terms of arbitrary and shifting concepts of what is money.

Representative **Reuss**. Would you consider it an adequate policy guide for a Federal Reserve System that you would approve of that the monetary managers try to do with money, credit, interest rates, and bank policy that which will best conduce to full employment without inflation? Is that good enough or would you refine that?

Mr. **Tobin**. Well, that's good principle both for monetary policy and for fiscal policy and I think that the two policies should be made in concert and be consistent with each other. Here in the Congress you should not pretend that you can have monetary oversight committees of the two Houses that can take care of monetary policy with Paul Volcker, or whoever is chairman while the budget committees handle fiscal policy, and never the twain shall meet. The same is true between the President and the Federal Reserve and the Congress. Macroeconomic policy should be an integrated task. We were talking about integration and coordination between governments and countries a while ago; it would be nice to have some within this one.

MONETARY-FISCAL COORDINATION

Representative **Reuss**. Would you, for the foreseeable future, have any idea that monetary policy is particularly important, because this country does need more real capital investment, and that low interest rates are particularly helpful in getting more capital investment; therefore, would you sail for a coordination policy which would let the Fed, as a starter, try a monetary policy that does bring about relatively lower interest rates, and then let fiscal policy conform to that? Or would you say that they both should leap out of their corners of the ring at the same time?

Mr. **Tobin**. Well, the planning for the budget is a once-a-year thing and monetary policy is made every month—maybe more often. It can adjust more rapidly. But certainly in these annual reviews of economic and monetary and fiscal policy they should be concerted, not just for a year ahead but for several years ahead. Then the operating responsibilities of the Federal Reserve from month to month would be to try to carry out the agreed policies and hit the agreed targets, not the agreed targets for some monetary concept—M_{1A} or M_{1B} or M_1 or M_{13}—that doesn't really matter except as an instrument of operation. What we're trying to do ultimately is not to control some M but to carry out a policy which uses all the eyes of the Governors and the members of the Open Market Committee have to look at interest rates, credit flows, employment, prices, production, and so on in a consistent manner in order to accomplish the concerted policy.

ECONOMIC INFORMATION

Representative REUSS. Mr. Leontief, I want to congratulate you for your op/ed piece in the New York Times a year ago entitled "If Mr. Reagan's Policies Flop, Then What?" The point of that article, and indeed of the central part of your testimony today, is that our economic information system in this country is inadequate, that it is vastly inferior to that of many other countries, including Japan. You make that case which you have been making for years, I think, with even greater strength today. It does not fall on fallow soil in the committee, because, as recently as a month ago, we published a study entitled "Maintaining the Quality of Economic Data," the general point of which was that the quality of economic data is not very good and should be improved.

We don't have in this country a parliamentary system so that it's very easy for one branch of the Government to work with another branch of the Government, but a few of the things you've said this morning lead me to wonder if it isn't possible for this committee, however small its resources are, to start a process which might lead to some improvements in economic information.

Just so you may have something definite to chew on, suppose this committee convened the various agencies and spinoffs of Congress which have to do in greater or lesser degree with economic information. I'm thinking here of the Congressional Research Service, the General Accounting Office, the Congressional Budget Office, and perhaps the Office of Technology Assessment. There may be others, but all of those are under our wing. Suppose one convened them and asked them jointly to produce a program which—taking our divided separation of powers, executive-legislative government as it is—would attempt to bring forth an economic information capability which we now don't have.

If such a collegial effort by Congress and its committees and its agencies could agree on something which would involve action by the various branches of the executive—Department of Commerce, Department of Labor, Office of Management and Budget and all the rest—it might be that the logic of this presentation was sufficient so that the two branches of government, executive and legislative, would both have to pull up their socks and see if it weren't possible to coordinate a better system of information of an economic nature so that the reindustrialization of America which everybody talks about would have a better chance of proceeding on a firmer foundation. Would such an attempt to get from here to there, as a starter, appeal to you?

Mr. **Leontief**. It certainly would appeal to me. I think it is possible. I think this approach has one positive element in it. It involves people whose opinions can diverge, which reminds me of this approach of the arbitration process in which you try to determine facts—and let's not forget, in the economic field, somebody knows most all the facts; it's the problem of organizing them. It's a problem of organization rather than just finding facts which nobody knows. And my feeling is that this initiative should be able to succeed. But personally I've had expression of the same willingness and interest to implement my policies from the other side, from the executive side, including in the present government, and my feeling is that if handled tactfully it can be done, and this would no doubt be a very great boon to the whole decisionmaking process. I think the problem with our decisionmaking process is this: One approach is don't do anything, send away the helmsman and just let the thing float. The other approach is suppose, if you don't have any marks at all, is to put your compass on 5 degrees, tighten it down and go to sleep—say 3-percent monetary growth or something like that. In other words, it is to establish some general rules of behavior and let the economy sail without watching where it goes. If you have no maximum goals nothing better could be done. But if you watch the situation, then you have to change your policy, coordinate your policy from one phase to another, as Professor Tobin said, not separately—fiscal policy and monetary policy separately—and let's not forget increasing productivity and negotiation of settlements as with the Japanese and many other nations.

As a young student I went to a dinner party and when we returned home after a couple of drinks four fellows sat in the front seat and one operated the brake, the other operated the accelerator, the third operated the clutch and the other one steered. Now it's a wonder I'm still here. This is a little bit like that, but in order to do it you need a map and what we want is help to provide the map information.

This is the most encouraging proposal which I've heard in a long time, particularly from such an authoritative source as you.

TECHNOLOGICAL CHANGE AND UNEMPLOYMENT

Representative **Reuss**. On another subject, Mr. Leontief, in your Adam and Eve, Garden of Eve metaphor, you talked about the progressive mechanization and automation of industry and the incipient technological unemployment that that brought about. Do you think there's something new in the world today, in at least the tempo of capital development which requires new directions of public policy?

Mr. **Leontief**. Yes, I think history never repeats itself. Technology never repeats itself. In the 19th century technology replaced physical labor. In old times when one hired a fellow you looked at his muscles to see if he was strong enough, if he was a good worker. If he was weak, you didn't use him. Now really physical labor is replaced by machinery and this was a 19th-century development. Electricity enabled us to transmit power much more and of course there was mechanization like the conveyor which simplified it. But the modern technology is intelligence. With the whole computer revolution the ordinary mental processes can easily be replaced. I read recently that in a grocery store a package can be examined in three dimensions by the machine to decide what it is and send out a bill—and speaking of monetary policy, what happens to the circulation of money when machines simply automatically charge your account in your bank? It will affect very much all the mechanics. And we've always said you just go and move in some other branch, but my feeling is the number of branches will be reduced, and this is very happy news because after all we don't want to work too much. We've had a work ethic always to force us to work as much as necessary, but in the long run many commodities or most of them will be provided without too much effort, so we'll have more time. This is why I always advocate reduction in the labor time and this is happening, but what happens now is very significant. In the 19th century people voluntarily reduced their working time because their income increased so fast that they preferred to take more vacations rather than more goods.

But now, with technology developing in such a way that the demand for labor is affected and consequently the upsurge of real compensation of labor I think is in jeopardy. So in this case the thing gets much more delicate. It will not be done automatically. We have to watch it.

I will conclude by saying that this is a new development, we don't do research in it. We speak about the wonders of technology but we did not make a comprehensive study. Many other countries did—how technology, if introduced, will affect what kind of labor and what industries. It's predictable. It's analyzable. We don't have it. I'm speaking simply from my intuition and what I read in the press—not the American press—in the Japanese press. I'm reading the Japanese press. They have constructed a big plant which produces automatic machinery. It's a very large plant, and they spent many millions of dollars on it; 12 workers are working, and at night everybody goes away and the plant operates. Now, of course, it will not happen now, but this is in the future and we must think about it. You must think about it.

EXCHANGE RATES

Representative Reuss. Mr. Klein, you spoke of the effect of high interest rates on inordinately strengthening the dollar. While that sounded good for a while—everybody likes the sound of a strong dollar and it makes imports cheaper—pretty soon the people who worked in International Harvester and Allis-Chalmers and various other American export industries found themselves losing their jobs because of the strong dollar; that is, we became unable to meet the competition of the Japanese, the Germans, the Italians, the French and everybody else who was blessed with a weak currency which enabled their exporters to go ahead and do their best to make jobs at home. I think your analysis of that process is right on target.

You say, and I'm quoting from your statement:

> Our aim should be to try to stabilize the American current account balance and the exchange value of the dollar. Given the key role of our currency in world trade, our partners want justifiably a steady dollar. Our doctrinaire monetary policies make for interest rates and exchange rate volatility, not stability.

I want to be sure I understand you on that. If what you're saying is what has been said many times before this morning, that we ought to pursue a somewhat less restrictive monetary policy and, or at least when we get out of the immediate doldrum we're in, a somewhat less expansive fiscal policy, I would heartily agree and say with that kind of an interest rate structure the American dollar internationally will be worth about whatever it ought to be worth. Who knows what that is. But at least it won't be artificially hyped up in a way that, while it may make our imports cheaper, makes our exports more expensive and thus produces disequilibrium. So far, so good.

Are you suggesting, however—and if you are, I think I might leave you—that we ought to conduct large-scale exchange rate operations to try to bring the dollar by manmade judgment into whatever we might think is its proper valuation? As you can see, I think that's not the way to go about it. In other words, I don't like the idea of pursuing policies at home, fiscal and monetary, which produce an overvalued or, for that matter, an undervalued dollar, and then instead of correcting the fundamental policy try to jigger the exchange rate of the dollar so as to relieve us of the consequences. I can't be sure from the words you used exactly what is in your mind on that.

Mr. KLEIN. Well, there are certain differences between having a strong dollar and having a steady dollar. I think what other countries want is steadiness and there are two considerations as far as economic policy is concerned. I think that the monetary authorities would be well advised to have a variety of targets, and to use the kind of analogy that we use in economic theorizing about this, they should try to optimize some kind of a weighted average, a loss or a gain function, of several target variables; I think the exchange value of the dollar might be one of them.

Now it's very difficult to intervene and fine-tune in international markets by just the right amount and not to make the dollar either undervalued or overvalued in terms of some basic considerations such as purchasing power parity. But another approach which would go in a different direction from the approach of expanding the monetary authorities' range of targets would be to reconsider Bretton-Woods' fixed parities.

I think that the Bretton-Woods system and the International Monetary Fund served the world very well for 25 years. There are many reasons why eventually it broke down, but it was designed to give a stable set of parities so that countries could pursue autonomous domestic policies as their situations required, and many of the considerations that were present in people's minds in 1945 or 1946 are again present now.

Now the floating rate system and having the very high interest rates and high exchange value of the dollar in 1981 prevented many countries from pursuing an independent or autonomous domestic policy.

After the oil embargo and after other things gave rise to the breakdown of Bretton-Woods, the whole system of exchange rates and international economic positions was in a state of flux and we have been making a very big adjustment. I think that adjustment period is probably well in order at the present time. I think this would be a good time to go back to a recalculation of the set of parities and if we had a Bretton-Woods type of organization that lasted for another 25 years, it would indeed be very good. I don't see any great disadvantage to the world economy and I see a number of advantages if we were to do that again.

Representative **Reuss**. So what you're saying is that exchange rates are a legitimate and necessary part of the calculus of domestic monetary authorities?

Mr. **Klein**. Yes.

Representative **Reuss**. But you aren't necessarily saying that we should get at the problem of exchange rate disequilibrium through exchange rate operations as such?

Mr. **Klein**. Well, if we have to—if there's a very serious adverse movement, either adverse to us or adverse for others, it may be necessary to keep that degree of flexibility open, but it is a very hard target to hit, given exchange rate values, and we haven't had all that much experience in the floating rate system to understand fully the mechanism of exchange rate determination. It's very complicated and, consequently, I would feel more comfortable for means of achieving stabilization in that area to reconsider an institutional mechanism like Bretton-Woods fixed parities, reapproached, recomputed, and maybe improved in its operating technique with the hope that it would serve as well in the 1980's and 1990's as the Bretton-Woods system served in the 1950's and 1960's.

Representative **Reuss**. Thank you. Yes, Mr. Tobin.

Mr. **Tobin**. I would just like to comment on that question, if I may, about the exchange rates and the international monetary system.

A big change happened in the world in the 1960's and then on into the 1970's, and that is the degree of international mobility of financial capital. It's just fantastic and the amounts involved that can move are very large indeed, and they are almost beyond the capacity of any government to withstand if there is a general movement against one currency toward another one.

That wasn't true in the early days of Bretton-Woods or through most of the periods in which Bretton-Woods worked so well.

And another factor in the success of the Bretton-Woods system, when it was successful, was that the dollar was the dominant currency in the world and the United States was the dominant economy. The system was managed by the United States which was always in surplus except when it didn't want to be, until things began to go bad in the 1960's.

So we can't go back to that system as easily as Larry Klein's remarks might have indicated. But that doesn't mean the floating rates are the solution to the problem.

The problem is basically that the interconnections of financial markets and the efficiency in a technical sense of offshore financial markets like the Eurodollar markets is so tremendous that it makes it difficult to have autonomous national policies. This difficulty is not remedied by having fixed exchange rates or by floating rates, either one. The only remedy for that is the coordination of policies between countries, the monetary policies we were talking about earlier, and more understanding between central banks as to what we're all trying to do. That might still leave some room for intervention in the market from time to time. One shouldn't have a great deal of hope that those interventions will alter what's going on very much, but they might oppose some clearly irrational speculative changes from time to time.

Representative REUSS. Well, isn't what you're both saying really that the enormous ease with which international capital now flows and the end of the day when the United States could unilaterally attend to the world's monetary needs—those two factors make it more important than ever that this country and every other important country adopt sensible overall fiscal, monetary, and general economic policies, because the failure to do so not only creates trouble at home, which it always has, but produces worldwide troubles which could lead to disaster? Can't you both agree with that proposition and leave to Mr. Klein his nostalgic hankering after another 25 years of Bretton-Woods and your feeling that it wouldn't work?

Mr. TOBIN. I'll agree to that.

Representative REUSS. Don't you think so?

Mr. KLEIN. Yes.

POLICY OPTIONS

Representative REUSS. We have imposed on your time inordinately, but let me close by descending from the sublime to the ridiculous and conduct a poll on a few propositions which some of us on the Joint Economic Committee have advanced as methods of getting this country out of the serious recession it is now in in as speedy and undiscombobulating a manner as possible.

I'll just put some of the propositions that we advance on the table to see whether you agree.

The four propositions are: First, accelerate that July 1, 1982 tax cut to January, this month. Now is when we need stimulus, not in the sweet by and by. Second, defer into indefinite status for a while the proposed July 1, 1983, tax cut. That could be just when we're running into a real inflationary buildup and we don't want to lock ourselves in concrete on that one. Let's wait until the day is a little closer before deciding what we're going to do. Third, have the President and the Federal Reserve not tighten money. In fact, have them moderately loosen monetary policy over what it is today. Fourth, develop some kind of a social contract incomes policy whereby labor trades some moderation in wage demands for a governmental commitment to some of labor's goals as well as an improved monetary-fiscal policy.

Those are the propositions we have advanced. Let me put them one by one and ask you if you agree to raise a hand and, if not, to so indicate.

One, accelerate the July 1, 1982, tax cut to January 1982. Would you favor that?

[All witnesses raise hands.]

Representative REUSS. Very good. Two, defer for the present at least the July 1, 1983, proposed tax cut.

[All witnesses raise hands.]

Representative REUSS. Very good. Maybe I should quit now. No, I'll go on. Three, let the President and the Federal Reserve at least moderately loosen monetary policy and lower interest rates starting at once.

[All witnesses raise hands.]

Representative **Reuss**. Very good, gentlemen. And four, develop some sort of a social contract incomes policy which would trade wage moderation, particularly as we emerge from the recession, for a fairer sharing of the cornucopia of life of working people.

[All witnesses raise hands.]

Representative **Reuss**. All right. The "ayes" are 12, the "noes" are none, and the motion to reconsider is laid on the table. We are very grateful both for your short term and your long term help. It's been a memorable session of the committee and we now stand in recess.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, January 20, 1982.]

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 20, 1982

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Richmond.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; and Chris Frenze, Kent H. Hughes, Paul B. Manchester, Deborah Matz, and Robert Premus, professional staff members.

Opening Statement of Representative Reuss, Chairman

Representative Reuss. Good morning. The Joint Economic Committee will be in order at its second annual hearing to ask the question, among others, whether we're really better off today than we were a year ago today when President Reagan was inaugurated.

Consider a few statistics: One, the unemployment rate a year ago was 7.4 percent. Last month it was 8.9 percent. The number of unemployed has risen by more than 1.6 million since last January.

Two, housing starts last year were 1.09 million, the lowest since 1946. This represents a drop of 46 percent from 1978.

Three, industrial production last month was 5.4 percent below the January 1981 level, with the drop in December the sharpest of the year.

Four, home mortgage rates, about 13 percent last January, currently average more than 17 percent. Yesterday the Wall Street Journal headline was "Much-Heralded Drop in Interest Rates Fades Soon After It Arrived."

Five, on Inauguration Day last year the closing Dow-Jones industrial average was 951. Yesterday it was 847, a drop of more than 100 points.

Six, just a moment ago the Commerce Department revealed that the drop in real gross national product last quarter was 5.2 percent, a really shocking and tragic figure.

We have known that we have been in a deep recession, but a lot of people are asking members of the Joint Economic Committee, "Are we in a depression?" Well, we do have a very clear arithmetic definition of what a recession is, and under that definition a recession started almost immediately after the completion of the Reagan economic recovery program at the end of last July. The definition of a depression is a little more subjective, but until a better one comes along I would think that a depression is what a country suffers when it is in a severe recession and the Government, instead of moving heaven and Earth to end the recession, passes the buck to the private sector.

It's very instructive to read what President Herbert Hoover had to say on that subject at the height of the 1929 Depression, and I quote from him:

> This is not an issue as to whether people should go hungry and cold in the United States. It is solely a question of the best method by which hunger and cold shall be prevented. It is a question as to whether the American people, on the one hand, will maintain the spirit of charity and mutual self-help through voluntary giving and the responsibility of local government as distinguished, on the other hand, from appropriations out of the Federal Treasury for such purposes.

Well, that has a very familiar ring to one who's been reading the official statements of the last few days. The sorry state of the economy is the direct result of President Reagan's program of huge tax cuts for the affluent, sharp increases in defense spending, leading to gaping deficits, and the tight monetary policies of the administration and the Federal Reserve. Because all of the President's proposals were enacted, the first year has provided a laboratory-like test of President Reagan's economic policy.

Outgoing Treasury Assistant Secretary Paul Craig Roberts was asked yesterday whether his departure from the administration was due to dissatisfaction with the direction of President Reagan's economic policy. His answer was, "None of us really knows what direction it's going, do we?"

Today we shall hear from a panel of four distinguished economists concerning their views on the direction of Reaganomics, the economic outlook for 1982, and policy changes which may be in order.

Our witnesses are: Mr. Barry Bosworth, senior fellow at Brookings; Mr. Michael Evans, president of Evans Economics; Mr. Richard Rahn, vice president and chief economist of the Chamber of Commerce; and Mr. Allen Sinai, senior vice president at Data Resources.

Gentlemen, we are delighted to have you here and we are grateful for the very comprehensive statements which you filed. Under the rule and without objection these will be received in full in the record. We now ask you to proceed. I think we will follow the order of seating. Mr. Bosworth, would you lead off?

STATEMENT OF BARRY BOSWORTH,[1] SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. BOSWORTH. Thank you.

I am pleased to appear before this committee to respond to the questions you have asked about the economic outlook and economic policy over the period of 1982 and 1983. I do not normally become actively involved in economic forecasts and my remarks in that area will be brief. I will concentrate on the proposals for policy.

---

[1] The views expressed in this paper are my own and are not necessarily those of the officers, trustees, or staff of the Brookings Institution.

ECONOMIC OUTLOOK

I believe we are in the midst first of a very severe economic recession in which unemployment is currently in excess of 9 million people. While technical factors have led to a slight overstatement of unemployment in December, it now appears that it will peak in the early spring months at about 9.5 percent of the work force or something close to about 10 million people unemployed. Because of cutbacks in unemployment insurance programs, only about one-third of those workers will be receiving unemployment insurance benefits. Thus, for those affected, it is likely to be a painful recession.

Most forecasts indicate that the decline in economic activity will end in the spring and an expansion will begin by July. The expectations of an expansion are triggered by the large tax cuts that will go into effect in July. I would like to raise some doubts that that expansion will be as strong as expected.

First, I believe the low point of interest rates is behind us and continued increases in future months will severely constrain the anticipated recovery of homebuilding and automobile sales.

Second, the large rise in the value of the dollar and the continued weak growth abroad will severely limit U.S. exports.

Third, on balance, the Government sector will not be a source of stimulus on the expenditure side, as cutbacks in nondefense spending at the Federal, State, and local level offset much of the rise in defense spending.

Fourth, because this was not a recession caused by excess inventory stocks with the resulting cutback in production, inventory corrections will not be a major source of expansions. That leaves only business investment and consumer spending—both affected by tax reductions—as major sources for economic expansion. But, low utilization of existing capacity and high interest rates will offset most of the tax incentives for business investment. I would anticipate an economic recovery, but I doubt that it will bring unemployment significantly below 9 million people.

The good news is that inflation is likely to continue to slow significantly—with this magnitude of unemployment it must. The past year has been dominated by some fortuitous events in food and energy markets, but monetary restraint also contributed. High interest rates raised the cost of carrying inventories and forced the dumping of many commodities on the market, and inflows of capital led to a significant rise in the exchange rate and thus cheaper imports.

These events are largely transitory in their impact on inflation, but together with the high unemployment, they have set the stage for a major break in wage inflation during 1982. In line with my prior beliefs that every percentage point of unemployment in excess of about 6 percent is worth about 1 percentage point in reducing inflation, I would anticipate that prices would rise about 7 percent during 1982 compared to 9 to 10 percent in 1981. The most significant event in that area to watch would be the course of the negotiations in the automobile industry that are now underway.

ECONOMIC POLICY

The economic policy situation seems to me to differ in two fundamental respects from the conditions surrounding the discussion of prior decades. First, the Government—and particularly the Federal Reserve—has decided to adopt a hard-line policy of demand restraint as a primary means of fighting inflation.

One consequence of this decision is that this recession is not an accident: It was the conscious and predicted result of policy decisions, and it should be analyzed as such. Whereas in the past, Government policy was directed toward minimizing recessions because of their unemployment consequences, it now accepts them as a cost to be paid to reduce inflation.

Second, within the overall policy demand restraint, the Government has also selected a mix of policy in which the monetary and fiscal measures are not coordinated with one another. While the monetary authorities emphasize restraint to reduce inflation, fiscal policy has been allowed to become extremely expansionary with large and growing budget deficits extending into the indefinite future. The collision between these two policies will be reflected in capital markets with high and widely fluctuating interest rates. One result will be a termination of the economic recovery in 1983; and perhaps even another recession if monetary conditions get as severe as they did in 1981.

My view of a weak economic recovery and continued high unemployment is primarily the result of believing the Federal Reserve when it says it intends to stick to its policy of sharply limiting the growth in the money supply. In effect, that policy puts a ceiling on the rate of growth of the economy over the next few years. It, and not fiscal policy, is the direct cause of the current recession, as it choked off what would have been a very strong recovery of the private sector in 1981.

On the other hand, the implementation of the 1982 and 1983 tax cuts together with sharply higher defense spending will push the Federal budget into a very large deficit position in future years. The administration had counted on a large expansion of the economy as a means of increasing future revenues despite the lower tax rates. The monetary policy, however, makes that outlook unlikely.

With a continuation of current policies, I would expect the deficit to be about $110 billion in 1982 and rise to $200 billion a year by fiscal year 1984 and continue to run at about 5 percent of GNP for the foreseeable future. The effort to cut expenditures outside of defense and social security has about run its course and revenues have been cut to the point that they cannot finance outlays at any potential rate of economic growth in the future. A year ago the President presented a graph of future revenues and expenditures in which the two lines intersected in the future—conveniently with no dates. If he ever plans to repeat that exercise today, he would have two lines that never intersect—still with no dates.

The administration can reduce these projections by adopting higher assumptions of future real output growth and lower forecasts of inflation. But as reported in the press, they, themselves, could not get the deficit below $160 billion for 1984. With dedicated accounting work, I think they could reduce this to about $140 to

$150 billion by measures such as asset sales and other financial transactions. But, by any measure, the deficits will be large without a change in basic policies.

I believe that current economic policy is backwards. I cannot agree with the basic policy emphasis on restraining economic growth because of the very high unemployment costs that it will imply and the damage done to capital formation and future trends in productivity growth. But, even if we accept the basic thrust of policy, the extreme emphasis on monetary restraint and fiscal ease, with its implications for very high interest rates, is the most costly of the possible means of reducing inflation and condemns the United States to follow the path of Great Britain. It will also prove to be very costly to the longrun goal of raising capital formation and productivity growth.

I would favor a far more restrictive fiscal policy because of the benefits that would accrue to capital formation. As long as the administration adheres to its program for defense, that objective can only be achieved by increasing taxes and cutbacks in social security. Since the latter is unlikely and because these trust funds have only minor effects on the overall budget deficit position, the issue is fundamentally one of higher taxes. The most straightforward means of achieving this would be to cancel the 1983 tax reduction and postpone the shift to indexation for 2 years. I would hope that the Congress could also repeal some of the costly special provisions that were tacked onto last year's bill. But, in fact, it will probably be difficult to avoid extending some such as "all-savers certificates" that are currently planned for termination.

Yet, while we emphasize the need for fiscal restraint, higher taxes will only further increase the damage to the economy, if we cannot achieve a "quid pro quo" on adopting an offsetting easing of monetary policy. I would recommend a shift in the mix of policy, but I certainly do not favor a more restrictive policy in total, which is what would happen if monetary policy cannot be moved from its current extreme stance.

Representative Reuss. Thank you very much, Mr. Bosworth. We will withhold our questions for the entire panel. Mr. Evans.

STATEMENT OF MICHAEL K. EVANS, PRESIDENT, EVANS ECONOMICS, INC., WASHINGTON, D.C.

Mr. Evans. Thank you very much, Mr. Chairman.

I appreciate the opportunity to appear in front of the Joint Economic Committee this morning.

As far as the outlook for 1982 goes, I believe the economy faces another poor year. While we do not expect the recession to continue much longer, the upturn will be unusually sluggish. The unemployment rate will remain above 8 percent for at least the remainder of this year. Car sales will average less than 9 million units, and housing starts will rise only to 1.2 million. The budget deficit will increase to approximately $90 billion for fiscal year 1982. While interest rates will decline somewhat from present rates, with the exception of the prime rate they will not be any lower by the end of the year than they were in December. The only bright spot on the horizon is that the rate of inflation will continue to diminish and will average under 7 percent for the year.

Real GNP is expected to show no increase this quarter, and then rise at only a 2- to 3-percent rate during the remainder of the year, compared to the historical average increase of 6 percent during the first four quarters of recovery. Thus, while the economy will post some gain during the year, the year-over-year change will show virtually no increase. Corporate profits will continue to be hard hit, declining over 10 percent on a yearly average basis, although they will be higher by the end of this year than they were in the fourth quarter of 1981.

While the general tendency is perhaps to blame the Reagan economic program for this sudden demise in the economy, in our opinion, the proximate cause of the recession is clearly the overly restrictive monetary policies and the high interest rates dictated by the Fed last summer.

For the first 6 months of 1981, we believe that the tight monetary policies followed by the Fed were correct. The inflationary legacy left by the Carter administration had to be overcome, and it was clear that the brief recession of 1980 had made no progress in this area. While inflation did briefly decline that summer, it roared back to 12 percent as soon as the economy recovered. With no fiscal restraint yet in place and productivity continuing to decline, it was necessary for the monetary authorities to diminish money supply growth.

After midyear, however, the situation changed significantly. The economy, while not yet in a recession, had returned to a period of extremely sluggish growth. The underlying rate of inflation was finally reversed, as indicated in the price of housing and other fixed assets. The money supply had shown virtually no growth since April, and the dollar was strengthening on world markets. Under such circumstances virtually everyone expected the Fed to ease up on the reins and permit interest rates to decline; yet instead they continued to move higher until the recession became an accomplished fact.

We are not by any stretch of the imagination suggesting that the Fed revert to a period of runaway monetary growth, which would invariably lead to higher inflation in 2 or 3 years, but rather that they keep money supply growth within the targets which they themselves have declared to be reasonable and proper.

The combination of recession and high interest rates is primarily responsible for the $90 billion budget deficit which we face in fiscal year 1982. Every 1-percent decrease in the rate of growth raises the Federal budget deficit by $10 billion, and in addition, the abnormally high level of interest rates relative to the rate of inflation had added another $20 billion to the deficit. Thus, $60 billion of the $90 billion deficit can be directly attributed to the effects of monetary policy rather than any changes in fiscal policy.

In addition, it is ridiculous to assign the blame of a large budget deficit to the Reagan policies, which have been in effect for less than 4 months. Even before taxes were cut by $1, the budget deficit reached $60 billion in fiscal year 1981. And it is an undeniable fact that Government expenditures excluding interest payments were lower in 1981 fourth quarter in constant dollars than they were in

1980 fourth quarter, in spite of the increase in transfer payments which is usually associated with a recession.

Even the harshest critics of the Reagan program generally admit that it is not the recession and high interest-rate-induced $90 billion deficit of fiscal year 1982 which bothers them, but rather the possibility of this deficit figure exploding to $150 billion or even $200 billion over the next 2 or 3 years. If the deficit were to increase to such lofty levels, it would indeed have serious implications for the stability of financial markets.

However, the $200 billion number is a figment of Dave Stockman's imagination and has no basis in reality. Even if the economy were to remain in perpetual recession as a result of tight monetary policies—a scenario which we think is extremely unlikely—the deficit would not reach such unmanageable levels. Under our standard forecast of a meager recovery this year but 4- to 5-percent growth in 1983 and 1984, the budget deficit should diminish to about $80 billion in 1983 and $60 billion in fiscal year 1984. But in order to justify this guardedly optimistic forecast, we need to look at the myths and realities of supply-side economics.

What I have called the four great myths of supply-side economics have caused the economy to move into recession and have resulted in at least the present and apparent repudiation of the Reagan program.

The first myth of supply-side economics was that interest rates would decline on the announcement of the Reagan program, even before any of the tax or spending cuts were implemented.

According to this first myth, it was to be the decline in interest rates immediately after Reagan took office which would be the cutting edge of his supply-side policy. The decline in interest rates would lead to lower prices, both because of the importance of the mortgage rate in the CPI and also because interest rates are one of the costs of doing business. Once this happens, wage rates and hence unit labor costs would decline, leading to a general reduction in the rate of inflation. At the same time, the reduction in interest rates would stimulate capital spending and housing, thus orbiting the economy into a period of rapid growth.

Unfortunately, almost precisely the opposite occurred. Long-term interest rates rose 4 percent, which was precisely the opposite of what the Reagan team originally expected.

This led to the second myth of supply-side economics which was that tight money policy and easy fiscal policy could coexist, with the former leading to lower inflation and the latter to faster growth.

Thus, as the economy began to stagnate again in the middle of the year, the third myth was touted out which was the demand for capital spending will rise because of the anticipated benefits of the tax cuts even while interest rates remained high and demand stayed sluggish.

Unfortunately, new orders for capital growth declined 10 percent in real terms in the first 2 months after the Reagan program was announced, thus completely wiping out the gain in new orders which had increased during the previous year.

The fourth myth and in fact the silliest one of all was that the budget could be balanced by 1984 even with the planned increases in defense spending and tax cuts.

This myth actually has two parts: The expected size of reflows and the amount that Government spending could be cut. According to the supply-side mythmakers, the tax cuts were supposed to generate so much additional growth in the economy that most of the initial tax cut would be offset by higher receipts stemming from the increase in personal income and corporate profits. In addition, the tax cut would switch assets into more productive uses at the high end of the tax scale and improve work incentives at the low end, thus making the reflows even stronger than usual.

As a matter of fact, previous experience with tax cuts has shown that the Government usually recaptures about 50 cents of every dollar of the initial reduction. However, in those circumstances inflation usually increases somewhat, and hence much of the reflows are simply due to higher prices. Last year, however, inflation declined from 13.4 percent to approximately 8 percent by the end of 1981. While we can all applaud the reduction in inflation, it definitely has the result of lowering the nominal incomes and hence reducing tax revenues. Thus the net result of lower inflation has been to reduce the reflows to zero.

Even this would not harm the budget position if Government spending were cut proportionately. However, this is almost literally impossible without attacking the areas of social security, indexation, entitlements, and defense spending, none of which either Mr. Reagan or the Congress has shown much interest in reducing.

The fact that these untoward events have occurred, however, does not necessarily mean that supply-side economics should be tossed out with the bath water. Indeed, we should examine the Reagan program to determine which parts of it are still valid and can be used to lead the economy to a period of rapid growth combined with declining inflation.

The realities of the supply-side economics I believe are that across-the-board personal income tax cuts will eventually lead to an increase in the personal saving rate, lower wage rate increases, and an increase in productivity through greater work incentives.

The increase in personal saving will lead to lower interest rates, higher investment, and increased growth in productivity, which will eventually lower the rate of inflation.

The major determinant of the real rate of interest is the total national saving rate. Increases in the budget deficit can result in lower inflation interest rates if they are offset by larger increases in private sector saving.

All of the beneficial aspects of supply-side economics take 2 to 3 years to become effective. In the short run, tax cuts that stimulate saving and investment may well lead to a contraction in the economy and an increase in the deficit, which is what we have observed in the last few months.

I think we should give supply-side economics a chance to act. I think that interest rates will move down in the second half of the year when the second phase of the tax cut goes into effect because of the increase in the national saving rate. As a result, I expect that we will have rapid growth in 1983 and 1984 of approximately

4 to 5 percent. Thus, I would not suggest changing the current Reagan program and I would not suggest changing the tax cuts. From a political point of view, however, since the financial markets have become so sensitized to high deficits, it is worth discussing what might be done to reduce the deficit. For if it must be done, there are better ways and worse ways to accomplish this goal.

In terms of Government spending, the major area in which I think spending should be cut is in social security payments. Except for a change in the indexation formula, I am not suggesting that payments be changed for existing beneficiaries. Instead, the retirement age should gradually be increased from 65 to 70 over the next several years. Every year the retirement age is advanced results in a $25 billion annual saving to the Federal Government. Partial indexation, on the other hand, would save much less, perhaps $3 or $4 billion per year.

The second major area in which spending should be cut is the area of medicare and medicaid benefits. The preferred method of operation here would be to add coinsurance and deductible clauses to existing methods of payments, which would save at least $10 billion per year once the changes were fully implemented.

The third major area where spending should be cut is in interest payments. Of course, presently, the Government has no choice other than to pay the going rate of interest on its debt. However, the introduction of gold-backed bonds would mean that such bonds would be essentially interest-free. If the long-term rate of inflation is going to decline sharply over the next decade, as we fully expect it will, then these bonds would appreciate very little in value and the Government would essentially pay a rate of interest which is close to zero.

The fourth major area is defense spending. While the United States desperately needs to upgrade its military capabilities in nonnuclear armaments, it is not clear the troops currently stationed in Europe are very valuable, although they are very expensive. A redeployment of these troops could save up to $10 billion per year.

The four changes suggested here would reduce the expected deficit for fiscal year 1982 by approximately $40 to $50 billion, or half of the total. This should be a substantial enough commitment to cause the financial markets to react favorably. If Congress felt that more reduction in the deficit were needed, the rest would have to come from tax increases.

While not in favor of any tax increases, I think that we can point out some that are the least worst. The most tragic change, in my opinion, would be to roll back across-the-board tax cuts which are scheduled for 1982 and 1983. This would not only terminate the experiment with supply-side economics, but would be tossing in the towel in our attempt to return to an economy which for the first 20 years of the postwar period resulted in a 3-percent annual rate of increase in productivity.

Such a rescinding of the across-the-board tax cuts would, in my opinion, raise the rate of inflation; increase the level of interest rates; reduce the rate of growth; and raise unemployment even further.

The rate of inflation would rise because taxes are a cost of doing business to corporations and a cost to the consumer in that it lowers real disposable income. Both of these would eventually be rejected in higher prices.

Interest rates would rise because the decline in the budget deficit would be more than offset by the reduction in private sector saving.

Finally, a tax increase would eventually withdraw purchasing power from the economy and lead to lower disposable income and output.

Tax increases which might be considered are as follows. First of all, I would be in favor of deregulation of natural gas, coupled with a windfall profit tax, which would raise approximately $40 billion the first year, although this amount would diminish in future years. While this would clearly be inflationary in the short run, it would rationalize our production, distribution, and consumption of energy, hence reducing the increase in energy prices and the rate of inflation in the long run.

The second major area where taxes could be raised is the ending of the deductibility for mortgage and other consumer interest. Such a reversal would encourage more private sector saving. Although it would raise taxes, it would increase saving in both the public and private sector, and hence would benefit the economy in terms of lowering interest rates and raising investment and productivity—thus eventually helping the beleaguered auto and housing industries.

The third major area where taxes could be raised is the rescission of the swapping of investment tax credits. While this newest tax benefit has some minor impact on investment, it is much less efficacious than the reduction in depreciation lives or a cut in the corporate income tax rate. It also has the unfortunate side effect of subsidizing the losers at the expense of the winners, thereby distorting and misdirecting capital market flows.

In summary, I think that supply-side economics has delivered just half a loaf. We were originally promised we would have higher growth and lower inflation simultaneously without any waiting. It has now turned out that we have had to go through a painful recession to reduce inflation, a recession which has been brought on not by the new style economics but the old style reduction in monetary growth rates. However, I think supply-side economics should continue to remain in force and that given an accommodative monetary policy, the tax cuts which are going into effect later this year and next year will eventually return the economy to higher growth rates and balanced, noninflationary growth.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Evans follows:]

PREPARED STATEMENT OF MICHAEL K. EVANS

The Economic Outlook for 1982

The economy faces another poor year in 1982. While we do not expect the recession to continue much longer, the upturn will be unusually sluggish. The unemployment rate will remain above 8% for at least the remainder of this year. Car sales will average less than 9 million units, and housing starts will rise only to 1.2 million. The budget deficit will rise to approximately $90 billion for FY 1982. While interest rates will decline somewhat from present peaks, with the exception of the prime rate they will not be any lower by the end of the year than they were in December. The only bright spot on the horizon is that the rate of inflation will continue to diminish, and will average under 7% for the year.

Real GNP is expected to show no increase this quarter, and then rise at only a 2% to 3% rate during the remainder of the year, compared to the historical average increase of 6% during the first four quarters of recovery. Thus while the economy will post some gain during the year, the year-over-year change will show virtually no increase. Corporate profits will continue to be hard hit, declining over 10% on a yearly average basis, although they will be higher by the end of this year than they were in 1981.4.

The sluggish economy clearly caught economic forecasters flat-footed within and outside the Administration alike. Last June the consensus estimate for real GNP growth in 1982 was 3.2%, compared to the expected rise of only 0.3% this month. While not everyone was as optimistic about supply-side economics as the Reagan team, the sudden decline in the economy last quarter came as a shock to virtually all economic forecasters.

While the general tendency is perhaps to blame the Reagan economic program for this sudden demise in the economy, in our opinion the proximate cause of the recession is clearly the overly restrictive monetary policies and the high interest rates dictated by the Fed last summer.

For the first six months of 1981, we believe that the tight monetary policies followed by the Fed were correct. The inflationary legacy left by the Carter Administration had to be overcome, and it was clear that the brief recession of 1980 had made no progress in this area. While inflation did briefly decline that summer, it roared back to 12% as soon as the economy recovered. With no fiscal restraint yet in place and productivity continuing to decline, it was necessary for the monetary authorities to diminish money supply growth.

After midyear, however, the situation changed significantly. The economy, while not yet in a recession, had returned to a period of extremely sluggish growth. The underlying rate of inflation was finally starting to diminish, and inflationary expectations were rapidly being reversed, as indicated in the price of housing and other fixed assets. The money supply had shown virtually no growth since April, and the dollar was strengthening on world markets. Under such circumstances virtually everyone expected the Fed to ease up on the reins and permit interest rates to decline; yet instead they continued to move higher until the recession became an accomplished fact.

We are not by any stretch of the imagination suggesting that the Fed revert to a period of runaway monetary growth, which would invariably lead to higher inflation in two or three years, but rather that they keep money supply growth within the targets which they themselves have declared to be reasonable and proper.

The combination of recession and high interest rates is primarily responsible for the $90 billion budget deficit which we face in FY 1982. Every 1% decrease in the rate of growth raises the Federal budget deficit by $10 billion, so that the 0% growth rate instead of an equilibrium rate of 4% has raised the deficit by $40 billion. In addition, the abnormally high level of interest rates relative to the rate of inflation has added another $20 billion to the deficit. Thus $60 billion of the $90 billion deficit can be directly attributed to the effects of monetary policy rather than any changes in fiscal policy.

In addition, it is ridiculous to assign the blame of a large budget deficit to the Reagan policies, which have been in effect for less than four months. Even before taxes were cut by one dollar, the budget deficit reached $60 billion in FY 1981. And it is an undeniable fact that government expenditures excluding interest payments were lower in 1981.4 in constant dollars than they were in 1980.4 -- in spite of the increase in transfer payments which is usually associated with a recession.

Even the harshest critics of the Reagan program generally admit that it is not the recession and high interest rate-induced $90 billion deficit of FY 1982 which bothers them, but rather the possibility of this deficit figure exploding to $150 or even $200 billion over the next two or three years. If the deficit were to increase to such lofty levels, it would indeed have serious implications for the stability of financial markets.

However, the $200 billion number is a figment of Dave Stockman's imagination and has no basis in reality. Even if the economy were to remain in perpetual recession as a result of tight monetary policies -- a scenario which we think is extremely unlikely -- the deficit would not reach such unmanageable levels. Under our standard forecast of a meager recovery this year but 4% to 5% growth in 1983 and 1984, the budget deficit should diminish to about $80 billion in 1983 and $60 billion in FY 1984. But in order to justify this guardedly optimistic forecast, we need to look at the myths and realities of supply-side economics.

The Four Great Myths of Supply-Side Economics

1. Interest rates would decline on the announcement of the Reagan program, even before any of the tax or spending cuts were implemented.

According to this first myth, it was to be the decline in interest rates immediately after Reagan took office which would be the cutting edge of his supply-side policy. The decline in interest rates would lead to lower prices, both because of the importance of the mortgage rate in the CPI and also because interest rates are one of the costs of doing business. Once this happens, wage rates and hence unit labor costs would decline, leading to a general reduction in the rate of inflation. At the same time, the reduction in interest rates would stimulate capital spending and housing, thus orbiting the economy into a period of rapid growth.

Unfortunately, almost precisely the opposite occurred. The more the financial community saw of the Reagan program the less it liked it. As it became clear that even more than the full complement of tax reductions were going to take effect, it also seemed more likely that political realities would preclude any more than token spending cuts taking place, although it is likely that spending would not increase in real terms. Hence, during the period from September 1980 to 1981, long-term interest rates rose 4%, which was precisely the opposite of what the Reagan team originally expected.

2. Tight monetary policy and easy fiscal policy could coexist, with the former leading to lower inflation and the latter to faster growth.

When it was clear that interest rates were headed up instead of down, the second myth of supply-side economics was trotted out. This myth was primarily based on the quantity theory, which has often been used to suggest that a decline in money supply would lead to lower prices. In fact, the bulk of empirical evidence does suggest that a change in money supply does result in a change of prices with approximately a two-year lag. However, the mechanism by which lower prices are reached is none other than a reduction in output. For another equation which is no less an identity than the quantity theory states that:

Prices = unit labor costs + gross profit margins* + excise tax rate

Hence the only way that a decline in the money supply can reduce prices is by lowering one of these three variables. However, since a decline in the money supply does not directly raise productivity or initially lower interest rates, it can affect prices only by squeezing wages or profits, which will not happen unless demand is diminished.

3. The demand for capital spending will rise because of the anticipated benefits of the tax cuts even while interest rates remained high and demand stayed sluggish.

When the application of tight monetary policies appeared to be leading the economy into yet another recession, thereby exploding the second myth, the third myth was proposed as the newest reason why the economy would post vigorous growth in 1982.

---

* including interest and depreciation expenses

To be fair about it, for much of 1981 it did appear that this myth had some substance. From June 1980 to August 1981, new orders for nondefense capital goods spending increased 10% in real terms and capital spending itself outperformed the increase in real GNP, the only time this had ever occurred during the first year of a postwar recovery. However, once the Reagan tax package was finally passed, the entire gain collapsed. During the next two months, new orders for nondefense capital goods declined 10% in real terms, completely wiping out the increase that had occurred during the entire previous year. It was this fact more than any other which has been responsible for the drastic downward revision in economic forecasts during the past few months.

4. The budget could be balanced by 1984 even with the planned increases in defense spending and the programmed tax cuts.

This myth actually has two parts: the expected size of reflows and the amount that government spending could be cut. According to the supply-side mythmakers, the tax cuts were supposed to generate so much additional growth in the economy that most of the initial tax cut would be offset by higher receipts stemming from the increase in personal income and corporate profits. In addition, the tax cut would switch assets into more productive uses at the high end of the tax scale and improve work incentives at the low end, thus making the reflows even stronger than usual.

As a matter of fact, previous experience with tax cuts has shown that the government usually recaptures about 50¢ of every $1 of the initial reduction. However, in those circumstances inflation usually increases somewhat, and hence much of the reflows are simply due to higher prices. Last year, however, inflation declined from 13.4% to approximately 8% by the end of 1981. While we can all applaud the reduction in inflation, it definitely has the result of lowering the nominal incomes and hence reducing tax revenues. Thus the net result of lower inflation has been to reduce the reflows to zero.*

Even this would not harm the budget position if government spending were cut proportionately. However, this is almost literally impossible without attacking the areas of social security, indexation, entitlements, and defense spending. Since Mr. Reagan has unequivocally declared all of these except entitlements to be off limits, the remaining budget cuts, while very real to those who are affected, have a relatively miniscule effect on the macroeconomic aggregates.

As a result of the propogation of these four myths, the economy is now in another recession, an unemployment rate which will remain above 8% at least through 1982, and a budget deficit which will reach approximately $90 billion in FY 1982.

The fact that these untoward events have occurred, however, does not necessarily mean that supply-side economics should be tossed out with the bathwater. Indeed, we should examine the Reagan program to determine which parts of it are still valid and can be used to lead the economy to a period of rapid growth combined with declining inflation.

---

* This was pointed out as early as August 1980 in my article "Those Disappearing Reflows".

The Realities of Supply-Side Economics

1. Across-the-board personal income tax cuts will eventually lead to an increase in the personal saving rate, lower wage rate increases, and an increase in productivity through greater work incentives.

2. The increase in personal saving will lead to lower interest rates, higher investment, and increased growth in productivity, which will eventually lower the rate of inflation.

3. The major determinant of the real rate of interest is the total national saving rate. Increases in the budget deficit can result in lower inflation interest rates if they are offset by larger increases in private sector saving.

4. All of the beneficial aspects of supply-side economics take two to three years to become effective. In the short run, tax cuts that stimulate saving and investment may well lead to a contraction in the economy and an increase in the deficit.

Both distant and recent historical evidence has shown that the vast preponderance of across-the-board tax rate cuts goes into saving. During 1964 and 1965, 88% of the Kennedy-Johnson tax cut was saved. More recently, personal saving rose $28 billion in October upon the occasion of a $15 billion tax cut. While this figure was abnormally high and was partially reversed in November, the preliminary evidence from the fourth quarter appears to indicate that virtually all of the most recent tax cut was also saved.

We must be fully cognizant of the fact that in the short run, an increase in saving means a decline in consumption; hence the initial effect of the tax cut may be contractionary. This additional saving will eventually be translated into lower interest rates, which will stimulate investment and productivity. However, this process will take two to three years and cannot realistically be expected to commence overnight.

Bill Niskanen has recently argued that budget deficits are uncorrelated with either the rate of interest or the rate of inflation, both for the U.S. and on an international basis; in short, that budget deficits don't count. Surely the argument cannot be that simple, for if it were, we would simply eliminate all taxes tomorrow and spend as much as we wanted without any fear of the hereafter.

However, the Niskanen analysis does spotlight two important lines of reasoning of which we should be aware. First, the largest budget deficits usually occur during a period when interest rates and inflation are declining. For example, in 1975 and 1976, the proportion of the budget deficit to GNP was far higher than even the pessimists are predicting for 1982, and yet both inflation and short-term interest rates declined to less than 5%. Clearly that deficit was largely recession-induced, although it also incorporated the $8 billion rebate. Yet it is clearly the high-employment deficit, rather than the actual deficit, which is relevant in determining the effect on financial markets.

Secondly, Germany and Japan, to choose two outstanding examples, have managed to keep their inflation rates at roughly half that in the U.S. while their budget deficits are proportionately more than twice as large. This occurs precisely because their private sector rate of saving is more than twice as high than in this country. This brings up the critical point that it is the total national saving rate, rather than the budget deficit alone, which is crucial in determining what happens to interest and inflation rates.

Thus, for example, we find a huge difference between a budget deficit which is caused by an increase in inflationary government spending and one which is caused by tax cuts which stimulate saving and investment. Rather than claiming that budget deficits don't count, we would argue that all budget deficits are not created equal. The Reagan tax cuts, through their emphasis on stimulating saving and investment, will eventually reduce the rate of inflation rather than exacerbate it.

Let us consider a tax cut structured in such a way that it is available only to those individuals who actually save more this year than they did last year. For every additional dollar saved, they received a tax credit of 50¢. Let us furthermore assume that this program is quite popular, so that personal saving rises by $40 billion while the government deficit increases by $20 billion. It would be absurd to argue that this increase in the deficit is inflationary and will raise interest rates; just the opposite effect should occur.

However, none of the beneficial effects from supply-side tax cuts will occur overnight. As we have already indicated, the initial effect of a tax cut which stimulates saving is to lower GNP rather than to raise it. Furthermore, the initial effect of a decline in inflation is to increase the budget deficit rather than to lower it. For while tax receipts are based on current income and profits, which are diminishing in nominal terms because of lower inflation, government spending, which is heavily indexed, is based on last year's rate of inflation. Thus during periods when inflation is diminishing, the budget deficit shows an artificial bulge. Once the rate of inflation stabilizes, this bulge disappears.

This process, by the way, is the exact reverse of what happens when inflation is increasing. During such periods, the budget deficit artificially shrinks, only to return in more virulent form as spending balloons in later years. Conversely, a decline in inflation will eventually shrink the budget deficit once the economy regains its footing, which is what we confidently predict will occur in 1983 -- providing that the Reagan program of further tax cuts is not rescinded. It is this last point to which we now turn.

What Should . . . and Should Not . . . Be Done

As long as the bulk of the deficit is caused by the recession and high interest rates, it is not a threat to raise inflation. From a strictly economic point of view, we believe that no further corrective measures are necessary. From a political point of view, however, and since the financial markets have become more sensitized to high deficits, it is worth discussing what might be done to reduce the deficit. For if it must be done, there are better ways and worse ways to accomplish this goal.

Before listing my choices for reducing the deficit, it should be made clear that none of these are politically easy choices. If they were they would have been discovered many years ago. They will require bipartisan support, well-directed coordination, and strong Presidential commitment. However, it is silly to proclaim at the outset that any of them are impossible.

The major area in which government spending could be cut clearly is social security payments. Except for a change in the indexation formula, I am not suggesting that payments be changed for existing beneficiaries. Instead, the retirement age should gradually be increased from 65 to 70 over the next several years. Every year the retirement age is advanced results in a $25 billion annual saving to the Federal government. Partial indexation, on the other hand would save much less. A reduction in the calculated rate of inflation by 2%, for example, would only save $3 to $4 billion per year. While such a move is also a step in the right direction, it is a very small one.

The second major area in which spending should be cut is the area of Medicare and Medicaid benefits. The preferred method of operation here would be to add coinsurance and deductible clauses to existing methods of payments, which would save at least $10 billion per year once the changes were fully implemented.

The third major area where spending should be cut is in interest payments. At present, of course, the government has no choice other than to pay the going rate of interest on its debt. However, the introduction of gold-backed bonds would mean that such bonds would be essentially interest-free. If the long-term rate of inflation is going to decline sharply over the next decade, as we fully expect it will, then these bonds would appreciate very little in value and the government would essentially pay a rate of interest which was close to zero.

The fourth major area is defense spending. While the U.S. desparately needs to upgrade its military capabilities in non-nuclear armaments, it is not clear the troops currently stationed in Europe are very valuable, although they are very expensive. A redeployment of these troops could save up to $10 billion per year.

The four changes suggested here would reduce the expected deficit for FY 1982 by approximately $40 to $50 billion, or half of the burden. This should be a substantial enough commitment to cause the financial markets to react favorably. If Congress felt that more reduction in the deficit were needed, the rest would have to come from tax increases.

Before discussing which tax increases are the least worst, in our opinion any increase in taxes would mark a critical step backward which would severely reduce the ability of the U.S. economy to resume a pattern of faster growth which was not accompanied by higher inflation. It would not only terminate the experiment with supply-side economics, but would be tossing in the towel in our attempt to return to an economy which for the first 20 years of the postwar period resulted in a 3% annual rate of increase in productivity.

This is especially true for rescinding the across-the-board cut in personal income taxes. For such a reversal would:

a) Raise the rate of inflation;

b) Increase the level of interest rates;

c) Reduce the rate of growth; and

d) Raise unemployment even further.

The rate of inflation would rise because taxes -- like wages, capital goods, and interest payments -- are a cost of doing business to the corporation and a component of the cost of living to individuals. As tax rates fall, wage rates rise less rapidly and pretax profit margins can shrink even as aftertax margins remain constant.

The Fed is currently controlling interest rates based on the growth in the money supply and the change in the amount of saving. If prices were to rise faster and saving were to fall, interest rates would simply increase even faster.

A tax increase would withdraw purchasing power from the economy and lead to lower disposable income. While most of the reduction would initially come out of saving, this would force interest rates up higher, thus causing capital spending and housing to decrease further.

Those who think this is merely fantasy are invited to direct their attention to the 1968 income tax surcharge of 10%, which was supposed to reduce inflation and lower interest rates by balancing the budget. The budget was balanced, all right -- in fact the NIPA surplus for 1969 was $8.4 billion -- but nothing else went right. Interest rates rose an additional 2%, pushing the prime to what was then considered a scandalously high 8½%, and inflation rose from 4% to 6% as the personal saving rate declined precipitously. This misadventure culminated in a credit crunch, a full-fledged recession, and yet left the underlying rate of inflation higher, a burden from which we are still trying to recover today.

Having said this, it should be clear that I am opposed to any tax increase in 1982 or 1983. However, if it is deemed politically necessary to raise tax rates, I would suggest that the following are less onerous than a rollback of the across-the-board tax cuts.

Deregulation of natural gas, coupled with a windfall profits tax, would raise approximately $40 billion the first year, although this amount would diminish in future years. While this would clearly be inflationary in the short run, it would rationalize our production, distribution, and consumption of energy, hence reducing the increase in energy prices and the rate of inflation in the long run. At present, natural gas drillers are bypassing gas which is less than 15,000 feet deep to drill for the most inaccessible, hardest to get gas because that is the category which is completely price decontrolled. This is akin to growing corn in Wyoming and mining coal in Iowa. Total deregulation would reverse this foolery.

The second major area where taxes could be raised is the ending of the deductability for mortgage and other consumer interest. Such a reversal would encourage more private sector saving. Although it would raise taxes, it would increase saving in both the public and private sector, and hence would benefit the economy in terms of lowering interest rates and raising investment and productivity -- thus eventually helping the beleaguered auto and housing industries.

The third major area where taxes could be raised is the recision of the swapping of investment tax credits. While this newest tax benefit has some minor impact on investment, it is much less efficacious than the reduction in depreciation lives or a cut in the corporate income tax rate. It also has the unfortunate side effect of subsidizing the losers at the expense of the winners, thereby distorting and misdirecting capital market flows.

Half a Loaf of Supply-Side Economics

It is still our forecast that Mr. Reagan's August 1981 plan, namely to hold spending constant in real terms, cut personal income taxes by 25% across the board, and reduce corporate income taxes through higher depreciation allowances and greater investment tax credits will, if given sufficient time, result in a resumption of rapid growth without rekindling the fires of inflation. To this end, we expect real GNP will increase in excess of 4% in both 1983 and 1984, with the rate of inflation remaining at 7%, if the Reagan program is left intact.

If this program is tampered with, the results could be quite disappointing. Specifically, if the second and third stages of the tax cut are rescinded, real growth would probably slow to 2% in 1983 and 1984 with inflation rising back to the 8% to 9% range. Interest rates would also increase from present levels instead of declining as is expected in our standard forecast. Furthermore, when the economy finally did resume 4% growth, inflation would return to the double-digit range. For with productivity showing no increase and labor trying to regain the wage increases which they are giving up in 1982, no effective break on cost-push inflation would be available.

Yet even though the existing Reagan program is the preferred alternative, it is clear that the results of supply-side economics have been far less successful than initially expected. This program was the original promise that the economy could have faster growth and lower inflation simultaneously and without waiting. Yet we have achieved lower inflation, not through new methods of supply-side economics, but through the old method of creating recessions with tight monetary policy.

Even this performance, it should be remarked, stands in stark contrast to those who believed that the Reagan tax cuts would intensify inflation, for precisely the opposite has occurred. Furthermore, it is only fair to point out that the Reagan programs have been delayed almost an entire year, and the beneficial effects of lower tax rates on saving, inflation, and work effort have only had a few months to develop. Finally, as mentioned earlier, supply-side results do not occur instantaneously, but take two to three years before the results are significant.

However, the early promises of the Reagan Administration, that 1982 would be a year of strong recovery coupled with lower inflation, are clearly unfulfilled. It is now apparent that the economy must go through an extended period of slowdown to wipe out inflationary expectations and reduce labor demands before it can once again settle down to a period of balanced, noninflationary growth such as occurred in the 1950's and early 1960's. In that sense supply-side economics has brought us only half a loaf instead of the full loaf of higher growth and lower inflation which was originally promised.

Representative REUSS. Thank you, Mr. Evans. Now, Mr. Rahn.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D.C.

Mr. RAHN. Thank you, Mr. Chairman. I am Richard W. Rahn, vice president and chief economist of the Chamber of Commerce of the United States and I appreciate the invitation to be here with you today.

We have a reasonably optimistic forecast which I will summarize for 1982 and 1983. For 1982, we expect at an increase in real growth, year over year, of 1.2 percent; and for 1983, 5 percent. Our unemployment forecast rate is 8.4 percent for 1982 and 7 percent for 1983. The average CPI increase we see for 1982, is 7.5 percent; and 6.5 percent for 1983. The prime rate averages 13 percent in 1982 and 9 percent in 1983. Our Federal deficit figures for 1982 are $97 billion and $86 billion for 1983.

Any economic forecast by its very nature involves some policy assumptions or a scenario. Our forecast is based on the belief that the Federal Reserve will be successful in maintaining their growth rate targets and have an average M_1 growth of about 5.1 percent between 1981 and 1983, and that that growth will take place at a relatively even rate and not be as erratic as we have experienced in the last 2 years.

We also forecast or assume in our forecast that the tax rate cuts which the Congress wisely enacted this past summer will remain in place; and third, we are forecasting or assuming that Congress will indeed maintain spending control by bringing Federal spending as a share of GNP from the current 23.3 percent down to 21.2 percent in 1983.

Our forecast in part is based upon the great benefits we see from the tax rate reduction. We have changed the relative prices of work and leisure, of saving, investment, and consumption. We expect substantial increases in the savings rate over this next year primarily due to the individual rate cuts which officially go into effect July 1; and of course, many taxpayers will be able to take them as of January 1 this year, effectively an average of 5 percent over the year, for those people who pay estimated tax payments.

In addition, the drop in the maximum rate from 70 to 50 percent which went into effect January 1—most of that will go into savings.

The second stage of the accelerated cost recovery system [ACRS] and, very importantly, the new universal IRA accounts, which allow $2,000 to be saved tax free by every working American, should give the personal savings rate an enormous boost.

We see a number of possible problem areas. The first is the Fed. Excessive or highly erratic monetary growth will increase inflationary expectations. We have seen particularly in 1981 the very erratic monetary growth and excessive growth for 1980 I should say gave us a very high rate of inflation and very high real rates of interest. This past year the average rate of monetary growth came down, but again it was erratic, resulting in still very high real rates of interest.

We saw in midyear when the Fed did get the growth rate of the money supply down and interest rates did fall rapidly from September to December. In recent weeks again we have seen large weekly growth rates in the money supply and, as a result, the interest rate dropped and the decline has been aborted for the moment.

We are reasonably confident the Fed will then soon get those high monetary growth figures under control and interest rates will continue to fall.

The second possible problem area we see is the lack of discipline by the Congress and the administration in spending control. Federal spending is still increasing as a share of GNP even though its growth rate has been brought down. The only areas left that have to be attacked are defense spending and entitlements. There still appears to be too much waste, fraud, and abuse in defense spending and too much duplication of facilities that perhaps are no longer needed.

Entitlements are still growing faster than the rate of inflation or the real rate of private sector growth. Congress and the administration must come to grips with both the indexing formula and the eligibility standards for the various entitlement programs.

In recent weeks there's been much discussion among some politicians and economists about raising taxes. The normal reason given for raising taxes is to bring down the deficit and the argument is made that we must bring down the deficit in order to reduce interest rates. I have a hard time accepting either of those assertions.

Over this past decade Federal taxes as a share of GNP increased substantially. Deficits went up. They did not go down. We have no real example either in this country or other places in the world where we have brought down deficits successfully over long periods of time through tax increases. A tax increase slows down the rate of economic growth, reduces the amount of employment, erodes the tax base, and increases the pressure on politicians to provide more Government services. It has, again, not worked here nor abroad in the past.

We have seen the example of Thatcherism in England; and I'm afraid if we give in to tax increases at this point that is the route we will follow. Even if the tax increases could bring down the deficit, we have no guarantee that interest rates would fall as a result. Interest rates are primarily determined by inflationary expectations and inflationary expectations are largely determined by monetary growth. It is the discipline of the Fed that is needed to bring down those inflationary expectations and subsequently interest rates.

If you have a deficit which falls as a result of erosion of savings through tax increases, the pressures will be as great on the Fed for monetization of the debt as they are now. However, you can have higher debt levels or deficit levels provided the rate of savings is growing faster than the deficit, which we believe will be the situation over the next couple of years.

Deficits are important, but they have to be looked at in relationship to the size of the gross national product and, more importantly, to the net saving in a society. The Japanese are now running deficits which are about 6 percent of their GNP, yet their rate of inflation is about 3 percent and their prime rate is under 7 percent. As our savings rate increases we will be able to afford higher deficits without the negative economic impact we have had in recent years. These deficits are not desirable and over the long term they ought to be brought down, but the only way to bring them down is through spending restraint.

If the administration, in cooperation with the Congress, continues on the program that they originally promised of ratcheting down the Federal share of GNP over the long run, these deficits will take care of themselves, given the current tax structure.

We believe that any decision to increase taxes at this time is a premature admission that the Congress and the administration do not have the will to get Federal spending under control. If we do not get Federal spending under control, we can only look forward to long-run stagnation.

In discussing possible tax increases there has been much discussion about various forms of excise taxes. One thing we must consider with the possible implementation of any excise tax is that by the nature of the way we calculate our CPI, these excise taxes go right into higher rates of inflation which again cause all those Government and non-Government programs that are indexed to the rate of inflation to soar, further adding to our problems.

It is hard to find a tax increase where the costs do not far exceed any possible benefits. Thank you, Mr. Chairman.

[The prepared statement of Mr. Rahn follows:]

PREPARED STATEMENT OF RICHARD W. RAHN

I am Richard W. Rahn, Vice President and Chief Economist of the Chamber of Commerce of the United States. On behalf of our 218,000 business, local and state chamber of commerce and association members, I welcome this opportunity to testify on the economic outlook for 1982 and 1983 and the risks attendant to that outlook.

I shall begin by outlining the specifics of our economic outlook and then turn to the economic policy risks which are so important to economic performance in the next two years and beyond.

The Economic Outlook

The economic recovery will be well underway by the second half of 1982. We expect year-over-year growth in real gross national product to be 1.2% in 1982 and 5.0% in 1983. The year-over-year increase in the Consumer Price Index in our latest forecast is 7.5% in 1982, falling to 6.5% in 1983.

We believe that over the next two years GNP growth will accelerate as inflation continues to wane. While employment has declined in the last four months as a result of the recession, we expect eight million more people to be at work between now and the end of 1983. Short-term interest rates will continue downward throughout 1982 and 1983. We expect the prime rate to average 12% in the last quarter of this year.

We expect the recovery to begin as early as the first quarter of 1982. This is based in part upon the very large pent-up demand for housing and durable goods relative to the very low levels of demand and production in the fourth quarter of 1981. A decline in the mortgage interest rate to the level of 14% - 15% will begin activity in this sector as it presents the opportunity for "buy downs" and other intermediate term arrangements at rates as low as 10 or 11%.

Although automobile sales in the first ten days of January continued the very low sales level from December, we expect sales to improve markedly within the next three months. The number of cars scrapped in 1981 was 8.35 million compared to 8.6 million sold. In 1978 the scrappage rate was 80% of cars sold. It is up to 97% in 1981. As the installment loan rate falls from the neighborhood of 17% and disposable income improves from the tax relief and lower inflation, and as consumer debt burdens lessen, automobile sales will improve. The expectation of lower inflation makes people feel wealthier as the purchasing power of their savings is higher.

The U.S. Chamber/Gallup Consumer Opinion Survey conducted 1480 personal interviews with a representative sample of U.S. adults in mid-December 1981. We found that there has been no noticeable improvement in the last three to six months in the percentage of people who say now is a good time to buy big things for the home, or to buy a car. However, asked about their financial situation, looking ahead to this time next year, 44% expect to be better off financially than they are now; 21% said worse off. Understandably, only 35% say they are financially better off now than they were a year ago; while 33% say worse off.

Consumers also appear to be gaining confidence regarding the future purchasing power over the year. Through most of 1981 the proportion in our Surveys who expected their incomes to rise less than prices during the next twelve months hovered around 60%. Yet this figure declined to 50% by mid-December. That is, 50% said they expected their incomes to rise less than prices during the next 12 months.

Business Fixed Investment spending will do better in 1982 than the consensus forecast and the latest Department of Commerce Plant and Equipment survey suggest. While businesses are unlikely to make more new equipment or construction commitments in the midst of a recession and in a turbulent bond market, they will soon see an increase in final demand. The tax incentives including accelerated depreciation and the leasing provisions for firms which cannot now benefit from accelerated depreciation will result in an earlier than usual recovery.

Another important factor lending new resiliency to business investment is business executives' assessment of the business climate.

In a survey of 1043 business executives in October and November of 1981 for our latest Business Confidence Survey, an improvement was found in their attitude toward "the general business climate--the ability to carry on business and make a profit." Sixty percent said the business climate "is more favorable" in November, up from 54% when the same question was asked six months ago and up from only 3% in the Spring of 1980. We cannot conclude from this that investment spending will increase faster while GNP is falling, but we can conclude that investment spending growth is likely to be stronger and more stable in the recovery period.

Economic Assumptions

In our forecast we have assumed that the money supply in terms of M1B will grow through the forecast period at an average annual rate of 5%. This is within the expected target range for 1982. The Federal Reserve Board may propose a different target range in testimony next month when they are required to outline their plans to the Congress.

We have also assumed that the Administration will be successful in obtaining many of the proposed cuts in next year's Budget although we will not see the specific proposed spending cuts until early next month.

Finally, we have assumed no tax increases in calendar 1982 and 1983 Our January Consumer Attitudes Survey finds that 59.5% of the public prefers that the 1982 and 1983 income tax rate cuts be effected as scheduled or effected six months earlier. Only 20.9% of the respondents wanted the income tax cuts postponed six months.

We also found overwhelming opposition to raising excise taxes.

Yet, by a margin greater than two to one, survey respondents favored additional reductions in federal spending.

Risks to the Outlook

There are three major risks to the outlook. The first risk is that the Federal Reserve will fail to keep monetary growth under control. The second risk is that Congress will fail to reduce the growth rate of government spending. The third risk is that the Congress and Administration will enact tax increases which delay the end of the recession and dampen subsequent growth.

Our forecast assumes a continuing and significant fall in interest rates, which can be brought about only by Fed policies which ensure slow and non-erratic monetary growth.

In the context of the short term forecast, the timing and vigor of the 1982 recovery will depend on how fast and how far interest rates fall -- in the next three months especially. Short term interest rates, as represented by the prime rate, have reached a temporary floor after declining very rapidly from 20 1/2% in September to 15 3/4% in December

1981. But the prime has remained at 15 3/4% since then and bellwether rates such as the rate on 90-day certificates of deposit have crept back up toward 13% from their December low. Rates on 13-week Treasury bills went above 12% last week after going below 11% in December. Clearly this illustrates renewed uncertainty on the part of short term lenders. Long term yields, including residential mortgage rates, have been rising -- also the result of uneasiness about the future.

A continuation of this uncertainty could adversely affect my relatively optimistic forecast of 4.3% real growth in business fixed investment spending in 1982. It could slow the growth in auto sales and drag out the recovery in housing starts. Thus, the outlook for 1982 and beyond depends mainly upon Federal Reserve policy which will reduce monetary uncertainty.

The main monetary risk is that the Fed will not hold the growth of money steady within the target ranges. Look at the record for 1981 -- not to mention the volatility of money growth in 1980 -- in terms of M1B. As compared to the last quarter of 1980 M1B grew at an annual rate of 5% in the first quarter of 1981. The next quarterly increase was at a 9% annual rate and then .3%. In the ten weeks ending January 8, 1982, M1B grew at a 12.4% annual rate. The target range for M1B growth in 1982 is 2 1/2% to 5 1/2%.

Money supply volatility and growth will have to be held in check to bring short term interest rates down further. We are cautiously optimistic that the Fed has learned from these recent mistakes.

Our forecast also assumes sufficient spending restraint on the part of the Congress to reduce federal spending from the current 23.3% of GNP to 21.2% by 1983 and 20% by 1984. It is apparent that, in order for

Congress and the Administration to accomplish this task, they must not only maintain their vigilance in attempting to remove waste, fraud, and abuse from all government programs including defense, but they also must be willing to find means by which to reduce the growth rate of entitlement programs so that those programs do not have greater attendant costs than benefits.

The additional risk is that the deficit will be reduced by tax increases. There is no direct relationship between budget deficits and interest rates. In fact, a review of the data reveals that interest rates have fallen during periods of deficit increases and increased during periods of deficit contraction. The reason for this is that interest rates are primarily determined by inflationary expectations which in turn are determined by monetary policy.

The only way to bring down deficits on a permanent basis is by maintaining non-inflationary monetary policies, coupled with spending restraint sufficient to reduce federal spending as a share of GNP and a tax structure that minimizes the impediments to work, saving and investing.

Conclusion

I have presented an optimistic forecast which we believe will occur unless economic policy makers in the Federal Reserve, the Administration, and the Congress again revert to the policies of the past. To avoid this, we continue to encourage the Federal Reserve to maintain a slow and steady rate of monetary growth and we again encourage Congress to enact real spending restraint and avoid the temptation to enact counterproductive tax increases.

UNITED STATES ECONOMIC OUTLOOK 1980-1983
Prepared by the U S. Chamber of Commerce

Percent change from previous period at seasonally
adjusted annual rates unless otherwise noted.

	QUARTERS								YEARS			
	Actual	Forecast							Actual	Forecast		
	81:3	81:4	82:1	82:2	82:3	82:4	83:1	83:2	1980	1981	1982	1983
GROSS NATIONAL PRODUCT												
Real GNP....................	1.4	-4.7	1.5	3.1	5.9	5.8	4.5	5.0	-0.2	2.0	1.2	5.0
Consumption................	3.3	-1.9	1.9	3.9	5.2	4.9	4.1	4.7	0.5	2.6	2.3	4.4
Residential Investment.....	-36.3	-11.0	-3.4	39.3	41.3	33.2	25.7	22.1	-18.6	-5.0	5.5	26.1
Business Fixed Investment.	7.1	0.3	4.9	4.3	6.7	10.5	8.7	8.9	-3.0	2.8	4.3	7.3
Equipment..................	6.3	-0.2	6.9	5.4	9.2	12.0	8.9	10.9	-4.2	1.8	5.0	8.6
Structures..........	8.4	1.8	0.7	1.8	1.1	7.0	8.1	8.5	-0.1	4.9	2.8	4.2
Exports............... ...	-3.4	-2.2	-1.1	1.8	4.1	6.3	7.0	7.2	9.6	-0.2	-0.1	6.3
Imports...........	5.3	8.3	2.0	3.5	8.0	9.4	5.9	7.1	-0.1	6.1	5.8	7.0
Government Purchases.....	-1.6	-3.0	-0.4	0.4	1.5	-3.6	-0.5	0.4	2.9	-0.2	-1.2	-0.4
Inventory Change ($ B).....	28	17	8	10	13	22	27	28	-6	18	13	30
New Car Sales (mil. units).	9.1	7.5	8.7	9.0	9.9	10.6	10.6	10.7	9.0	8.6	9.6	10.8
Housing Starts (mil. units)	1.0	0.9	1.1	1.3	1.5	1.7	1.7	1.8	1.3	1.1	1.4	1.8
EMPLOYMENT WAGES AND PRICES												
Unemployment Rate (%)......	7.2	8.4	8.9	8.5	8.3	8.0	7.8	7.0	7.1	7.6	8.4	7.0
Compensation...............	9.3	8.4	8.1	8.1	8.0	8.0	8.4	8.2	9.9	10.1	8.3	8.1
Productivity...............	-2.0	-1.1	1.5	1.6	2.4	1.9	1.7	2.3	-0.3	1.2	1.2	1.6
Unit Labor Costs...........	11.1	9.8	6.6	6.4	5.7	6.1	6.6	5.9	10.3	8.7	7.0	6.5
Consumer Prices............	11.9	8.5	6.5	6.3	6.7	6.9	6.9	6.2	13.5	10.3	7.5	6.5
GNP Deflator............ ..	9.9	9.3	6.1	6.6	6.5	7.1	6.8	6.4	9.0	9.2	7.4	6.8
Prime Interest Rate (%)....	20	17	14	13	12	12	10	9	15	19	13	9
Profits from Current Production ($ B)*	118	115	111	108	113	124	126	138	100	116	114	144
GOVERNMENT FISCAL POLICY ($ B)										FY81	FY82	FY83
Unified Budget -- Receipts.										603	636	691
Unified Budget -- Outlays..										661	733	777
Unified Budget -- Federal Surplus or Deficit.......										-58	-97	-86

* Corporate profits after tax with inventory valuation and capital consumption adjustments.

SOURCE: U.S. Chamber of Commerce, Forecast Center.

FORECAST ASSUMPTIONS

- The growth in federal nondefense expenditures is reduced by $31 billion in fiscal 1982 and $78 billion in fiscal 1983.
- The Federal Reserve is assumed to restrict the growth of M1B to an average of 5.1% per year from 1981 to 1983.
- A phased-in reduction in personal tax rates with cuts of 5% in October 1981, 10% in July 1982, and another 10% in July 1983. Additional revisions in the tax code such as the reduction in the maximum tax rate on "unearned income" to 50% in 1982 are effective January 1982. The static revenue reductions (at annual rates, before growth feedback) are $15 billion in 1981, $33 billion in 1982, and $78 billion in 1983.
- Business tax cuts consist of depreciation reform along the lines of the "15-10-5-3" formula; an increase in the investment tax credit for equipment, and tax credits for research and development and investment for rehabilitating certain structures. The static revenue reductions are $5 billion in 1981, $11 billion in 1982, and $17 billion in 1983.

Representative REUSS. Thank you, Mr. Rahn. Mr. Sinai.

STATEMENT OF ALLEN SINAI, SENIOR VICE PRESIDENT, DATA RESOURCES, INC., LEXINGTON, MASS.

Mr. SINAI. Thank you, Mr. Chairman, for this opportunity to testify on economic policy and the economic outlook.

More than at any time since the 1930's, the course of economic policy is now determining the performance of the U.S. economy. We have many new policy experiments set in place in the past few years, including an easy fiscal-tight money policy mix set in place by Reaganomics and the new Fed policy; a major shift in the role of the Federal Government vis-a-vis the private sector; deregulation of many areas of the U.S. economy; a more laissez-faire attitude toward mergers and acquisitions; and new approaches in the setting of wages.

Are these new policies working? Certainly, with regard to the principal goal of reducing inflation there has been much progress. This past year U.S. inflation rates dropped sharply and the price-wage-price spiral showed signs of a secular turn downward. However, in the process of fighting inflation, other problems have been created. In particular, repeated clashes between the monetary restraint of the new Fed policy, renewed growth of the economy, and large Federal budget deficits have led to unprecedented levels of nominal and real interest rates. The results have been an increasingly severe recession, massive unemployment, chronic stagnation for the economy, severe financial strain, and threats to the viability of many corporations, even greater Federal budget deficits, and rates of inflation that are still unacceptable. It is probably fair to say that these new problems are bringing another crisis of confidence over the ability of the U.S. Government to deal effectively with the economy.

Although it is much too early to expect the new policies to fully resolve the problems of the U.S. economy, it is always appropriate to reevaluate and reexamine them to find changes that could help bring better results. The possibility that the new policies of Reaganomics and the Federal Reserve need to be readjusted or fine-tuned is not really a negative reflection on the administration or central bank. No radically new set of policies could possibly work smoothly in practice without some modification as developments unfold. Indeed, this is the time to begin to make some of those modifications and changes because one thing is for sure, without adjustments now in the current thrust of policies, the U.S. economy runs the risk of a major collapse, unprecedented in the postwar period.

Let me turn now to the highlights of my prepared statement as they relate to the questions raised in the chairman's letter.

First, on the economic outlook, we believe the economy currently is in a relatively severe recession. The drying up of orders in the fourth quarter, a large 2.1 percent drop of industrial production during December, rising inventory-sales ratios, a jump in the unemployment rate to 8.9 percent, and only an 0.2 percent rise for personal income confirm that a broad-based decline is in process throughout much of the U.S. economy. Survey data on consumer sentiment, business plans for capital outlays as published by the Department of Commerce, and the monthly report of the National Association of Purchasing Agents all indicate that the downturn will continue in the early part of this year. A somewhat higher rate of auto sales in early January, flat retail sales in real terms, a slight upturn in housing activity, and lesser declines in the leading indicators do suggest that the pace of deceleration has slowed. But with production, employment, and inventories to be cut further and negative impacts on income from rising unemployment, it is clear the bottom of the recession has not yet been reached.

The situation appears quite bleak, with essentially no growth in the U.S. economy since 1979. Industrial production is well below that of early 1979. Retail sales, in real terms, are far under the 1979 figures. Auto sales are 4.4 million units below the peak that was reached in 1979. Housing starts are almost 1 million units lower than the June 1979 peak. And, the factory utilization rate for all manufacturing is only 72.9 percent compared with 87.2 percent in March 1979.

Our current forecast shows the recession continuing into spring and then a restrained expansion with ebbs and flows in real economic activity reflecting the new volatility of the U.S. economy. A slow process of disinflation is forecast to occur, with inflation rates in a 5- to 7-percent range during the first half of 1982, reflecting the cyclical impact of the recession. Thereafter, inflation rates fluctuate considerably but are lower, on average, for the next few years. We think there will be a sharp rise in joblessness over the next 6 months, with the unemployment rate possibly exceeding 9.5 percent in some month next spring and the number of unemployed going to over 10 million people, which would be the highest number of jobless since the Great Depression. Interest rates should resume declining after the current bulge in the money supply is absorbed, reflecting very positive fundamentals for the money and capital markets, but then rise in the second half. Both the auto and housing sectors probably have bottomed out, but will exhibit only modest improvement for the rest of this year.

Our forecast for the current recession is near the average for the postwar period in length and depth. The trough is forecast to occur in May, with the peak-to-trough decline in real GNP at 2.8 percent. The 11-month duration for the recession and decline from peak-to-trough are quite close to the average 10.1-month length for seven other postwar recessions and the 2.4 percent average decline in real GNP. Industrial production is forecast to drop 8 percent, compared with the average 11.7-percent decline for the other recessions. But those average numbers really do mask the dangerousness of this recession.

We are in a second dip of a "double-dip" episode, with big downside risks still remaining. Most of the risks center on the role of monetary restraint in any new upturn and the potential clash between progressively lower targets for monetary growth and growth in nominal GNP. Under the new Fed policy, renewed growth in nominal GNP, rises in credit demands, and increases for the monetary aggregates can automatically bring substantial rises of nominal and real interest rates. In the new environment, quick responses by the central bank to above targeted monetary growth, perhaps even during a recession, and fiscal stimulus make a high interest rate environment inevitable with far-reaching effects on the economy. Thus, the possibility exists that no expansion can be sustained unless inflation rates drop by more than expected, the central bank relents on its policy of restraint, or the fiscal stimulus of the Reaganomics tax and spending programs is limited.

The danger of the current recession, however, lies in more than just the possibility that any recovery will be aborted by the new Fed policy. Already the recession has become very broad based; both geographically and across sectors, industries, and firms. Few areas are now escaping the impacts of this second recession in 2 years, which was originally concentrated in the Midwest, East South-Central, and East North-Central regions. Even New England, the Pacific coast and Middle Atlantic regions are now being impacted. The chronic stagnation of the U.S. economy since 1979 makes it difficult for any area in the country to escape unscathed.

The toll by industry, sector, and firm—potential toll—of this 3-year period of stagnation brought about by tight money and the resulting squeeze on cash flow, is really fairly long to list. We have industries such as airlines, agriculture, agriculture machinery, autos and auto-related, building materials, construction, copper—this is not in alphabetical order—housing, forest products, home furnishings, aluminum, lead and zinc, real estate, steel, railroad equipment, and trucking—these industries are all chronically recessed. Certain sectors of the economy, such as thrift institutions, must scale down operations to a permanently lower level of activity and are in danger of near extinction if we cannot turn the current pace of economic activity around and ease the monetary squeeze.

Another casualty of the high interest rates and slack economic environment is business capital formation. Despite the stimulus from the accelerated cost recovery system, business spending on plant and equipment, adjusted for inflation, is not forecast to strengthen until 1983 and 1984. The 5.1- and 6.5-percent rises predicted for those years represent a solid expansion, but considerably less than in most business recoveries. High interest rates, especially long term, restrain business capital formation to a significant extent by raising the required rate of return on investment and preventing the restructuring of balance sheets toward longer debt maturities that has always been necessary before a capital spending boom.

It has not been unusual for business capital spending in real terms to rise by over 10-percent rates for 2 and perhaps 3 years after a recession, so these numbers of 5.1 and 6.5 percent really do represent the toll which we think will be taken by the continuing high interest rates necessitated by the current mix of policies.

But we do think inflation rates are permanently in single digits now. With so much slack in labor markets and low operating rates, it would be hard to get a significant reacceleration of inflation unless we had some external supply-side shocks.

Our forecast for the implicit GNP deflator is for a rise of 7.5 percent this year, 7.7 percent in 1983 and 7.2 percent during 1984.

For a better performance on inflation to occur, there must be a major breakthrough toward substantially lower wage settlements.

With the demand-side elements of inflation mostly eliminated now because of the cyclical downturn in the economy, only the cost-push component of inflation remains. Its largest component by far is wage increases in excess of productivity growth. Since there is little hope for a major upturn in the growth of productivity under the current easy fiscal-tight money twist of policy, the only way to achieve greater gains on inflation is through much lower rises in wages.

How can we achieve that? It may happen simply because of the recession. We are not forecasting a major downturn in wage inflation for 1982, although recent events do suggest that the improvement could be better than expected, given the negotiation results between the oil, chemical, and atomic workers and that industry and the agreement between the Teamsters Union and the trucking industry. Other ways to continue the deceleration of wage inflation forward, however, would be to try a TIP program, to apply tighter fiscal policy, or further monetary restraint.

As my remarks will indicate, I'm not for further monetary restraint, so I don't think that's the way to propel the wage improvement further. It will either come about as a fallout of the recession or as a result of some policy such as an incentive-based tax policy.

As for interest rates, we think they are going to be high forever, where forever is the next few years, given the current mix of policy. High nominal and real interest rates are assured by the current mix in policy and the new volatility in the financial markets. There must be an additional premium in interest rates from the increased volatility of the financial markets. That is part of why interest rates stay so high even as inflation rates come down and the economy goes into a deeper recession. The other reason is the particular mix of policy which calls for high deficits in the next 2 years. Heavy tax cuts, and good economic growth simply will not fly with the kind of targeted growth rates that the Federal Reserve has set.

The result is that interest rates will continue on the roller coaster that has been in place for the last 2½ years, going down some in the first half, rising 100 to 400 basis points in the second half of this year, down early in 1983, up again, and so forth.

The real question is, will interest rates go back through the previous peaks? Given the current course of policy, there is a real risk of that and then another severe downturn in 1983.

We are assuming that the Federal Reserve keeps to their policy of gradual reductions in the growth targets for M_1 over the next few years. This means 2.5 to 5.5 percent for this year, 2 to 5 percent for 1983, and 1.5 to 4.5 percent in 1984. These lower growth goals budget the growth of nominal GNP to be in single digits.

Given the success so far on inflation, the tough approach by the Fed and support by the administration on the basic thrust of monetary policy, it is imprudent to assume that the Federal Reserve will relent on these monetary growth targets.

Our forecast of monetary policy also is contingent upon some tightening of the budget by the Reagan administration for fiscal years 1983 and 1984 to the tune of some rises in taxes, some cutting of spending. If they don't do that, I would expect that monetary policy will turn even tighter than we are assuming for the years 1983 and 1984.

Turning now to the deficit and its impact, we estimate—and these estimates are shown in table 14 of the prepared statement—we estimate that the NIA deficits will be in triple digit figures for fiscal year 1982 through fiscal year 1984. I will explain what underlies these estimates in a moment, but the numbers are $108 billion in 1982, $112 billion in 1983, and $110 billion in 1984.

The assumptions about real economic growth, inflation, and interest rates and the unemployment rate also appear in that table and they are the following: The real GNP drops 0.7 of a percentage point in 1982, is up 4.1 percent in 1983, and up 3.5 percent in 1984. There are the near 7-percent inflation rates that I indicated and Treasury bill rates that will range between 11 and 15 percent.

Now without some assumptions that we have made on the course of policy to be taken in the budget to be announced by President Reagan within a couple of weeks, these deficits would be much larger. They would be $120 billion for fiscal year 1982, $152 billion for fiscal year 1983, and $189 billion for fiscal year 1984.

We have made a forecast of what fiscal measures will be taken to get the deficits down to the triple digit numbers that I have talked about; that is, near the $110 billion figure. We have assumed that there will be new excise taxes on liquor and tobacco, that there will be an increase in the gas tax, that there will be a 50-percent windfall profit tax on natural gas as a result of accelerated decontrol of "old interstate" gas, and some modest reductions of military spending from the 7 percent real rates desired by the Reagan administration. We have assumed sizable reductions in nonmilitary spending, and sharp cutbacks in grants-in-aid to States and localities.

Why did we assume this? It seems very clear that it is unlikely that the Reagan administration and Congress will eventually propose a budget that could result in deficits approaching $200 billion by fiscal year 1984. This is really too much for anyone to accept and to believe in terms of its potential harmfulness. Indeed, budget deficits of the magnitude of over $100 billion in this new era with the new Fed policy are potentially very damaging to the U.S. economy.

These deficits that we are forecasting with the policy changes mentioned are at record levels, although not so as a proportion of nominal GNP. For fiscal year 1982, the deficit is mostly passive. A passive deficit is the result of a weak economy, lower inflation rates, still high interest rates, and only a small amount of fiscal stimulus. But in fiscal years 1983 and 1984 the deficits are active, occurring in an economy that is growing above potential, with inflation rates that are rising or stable, and from a large injection of fiscal stimulus. The active deficits are the dangerous deficits because the new Fed policy and the accompanying financing by the U.S. Treasury will not be accommodated unless monetary growth is within or below Federal Reserve targets. Thus, the impacts of a given deficit in the new structure can be expected to be higher interest rates and less expansion by interest rate sensitive sectors of the economy than before this policy was implemented in 1979. A further paradox is that a rising deficit itself can bring about an even worse deficit through raising interest rates, slowing real growth, increasing unemployment, and restraining inflation. Measures to reduce the deficit, such as raising taxes or lowering spending, could reverse this set of results. This would be very restrictive on the economy unless accompanied by some offset in monetary policy.

What are the impacts of large deficits? Historically, the periods of largest deficits have been associated for most of history—I want to make this distinction because it's changed in the last 2 or 3 years—the periods of largest deficits have been associated with interest rates that were declining or at troughs. This was the case in 1958, 1967, 1970–71, and 1975–76, where record deficits in absolute and relative terms, as a proportion of nominal GNP, were associated with declining short- and long-term interest rates.

The explanation for this is straightforward. Most of these deficits were passive, the result of lessened tax receipts from a weak economy, declining rates of inflation, and higher transfers for the unemployed and welfare support. At the same time, the slack in the economy was substantial with high unemployment rates, low capacity utilization rates, and large gaps between potential and real GNP. A reacceleration of inflation has been slow to occur in these circumstances.

In the situation of a passive deficit in those years, the private sector generally spends less and borrows less and rebuilds the financial side of the balance sheet. This is the process that we named reliquefication back in 1975. The lessened credit demands of the private sector and greater demands for financial assets have proved complementary to the heavy financing needs of the U.S. Treasury, with demands for high-quality U.S. Treasury securities outweighing the supplies and causing declines for interest rates. At the same time, the Federal Reserve—and sometimes the rest of the world—was a big purchaser of the new Treasury debt and that helped to depress interest rates as well.

But for the future, the impact could well be different. Indeed, in 1980 and 1981 rising deficits were associated with rising interest rates and were a departure from the previous historical experience. This occurred despite a double-dip recession. In part, rising or still high inflation rates helped to prop the interest rates. But perhaps most importantly, the Federal Reserve was not a major buyer of new Treasury debt issues. The portion of U.S. Treasury debt picked up by the Federal Reserve since the new Fed policy has been considerably less than in previous years. This is shown in table 17 of the prepared statement. In 1980, the central bank absorbed only $4.4 billion or 3.5 percent of the issues. The estimates for 1981 so far are $2.1 billion and 1.6 percent. In other years of high deficits and declining interest rates, the central bank purchased from 9 to 38 percent of the total that was issued. So the Fed is not affording the same support as it did in previous periods when high deficits were associated with falling interest rates. The Fed is simply not monetizing nearly as much of the debt as it did in other times. Also, private sector spending has not been weak for long enough to generate the sustained reliquefication necessary to more fully absorb U.S. Government debt issues. Thus, the higher pattern of interest rates and higher deficits are a warning for the future, although ultimately the impact of the deficit on rates must still depend greatly on the cause of the deficit and initial conditions in the economy. However, there's no doubt in my mind that a given deficit under the new Fed policy, all other things being equal, will bring about much higher interest rates than in previous instances.

Now our real problem is not 1982, because in 1982 the deficit will be passive. The real problem is in fiscal years 1983 and 1984 when the deficits will be active. A large volume of Treasury financing under the fiscal stimulus of Reaganomics in those years could and very likely would clash with an expansion of economic activity in the private sector to bring sustained high or rising interest rates. In the extreme, it is even possible that the economic expansion could abort, with no real gain because of the clash between monetary and fiscal policy. Expectations effects on the financial markets from the prospects of the fiscal stimulus to come in fiscal year 1983 and fiscal year 1984 and heavy Treasury financing in being reflected in the bond markets already, in a "rational expectations" implication of these policies. It is rational to expect heavy fiscal stimulus and heavy Treasury financing under the new Fed policy to result in much higher interest rates than have ever occurred before and the bond markets are seeing this and they are saying it. They are discounting this prospect and that is one reason why bond prices have remained so weak and bond yields so high, despite the very weak economy and the very low rates of inflation we have seen for the past 6 months. This result has been counterproductive and will be counterproductive since it limits capital formation and productivity growth, thus interfering with further progress on inflation.

Therefore, it is absolutely necessary for the administration and Congress to make a major move to tighten the budget so as to relieve potential pressure on inflation, to ease congestion in the financial markets, to make it easier for the Federal Reserve to ease monetary policy and, of course, to reduce inflation expectations further. A turn toward a tighter fiscal policy would weaken the economy and since we don't want that to go too far in what already is a chronically recessed economy, it would induce the Federal Reserve to inject bank reserves to sustain the targeted rate of monetary growth in a turn toward easier monetary policy. So long as the central bank did not exceed its targeted money growth rates, the slack built up by the tighter fiscal policy would be offset by lower interest rates. Interest rate sensitive activities in the economy would be stimulated without reigniting inflation.

Now we have looked at this new twist of policy, turning monetary policy easier in response to a tightening of the budget with the DRI Quarterly Model of the U.S. Economy under three programs of fiscal restraint. I only want to talk about one of them and I will lay out the scenario and give you some idea of the results.

In the first one, which is labeled "stringent budget restraint" in my prepared statement, there is a $119 billion swing toward a more restrictive budget by fiscal year 1984, consisting of reductions in spending and increases in taxes across the board. I think the composition of these spending cuts and tax increases, while a subject of great debate, are less important for purposes of illustrating the macroeconomic results than getting into the details of it.

The composition of the cuts in spending were assumed to be a modest reduction in military spending, $5 billion in fiscal year 1983 and $10 billion in fiscal year 1984; about $11 billion of reductions in nondefense spending in fiscal year 1983 and $23.5 billion in fiscal year 1984; grants-in-aid to States and localities were lowered in this scenario by $20 billion in fiscal year 1983 and $30 billion in fiscal year 1984, but we did return some of the revenues from tax increases to the States.

On the tax side, personal income tax reductions were halved to 5-5-5 rather than 5-10-10. The object was to preserve the thrust of reducing marginal tax brackets across the board but not to make it quite so extreme as the 5-10-10. It keeps in spirit with the supply-side notion that this would be helpful but simply cuts the dosage down a little bit. That change raised $33 billion in new receipts by fiscal year 1984. Excise taxes on liquor and tobacco brought new receipts of $5 to $11 billion, and then a windfall profit tax on deregulated natural gas raised $3 and $6 billion; $4 billion was raised by a hike in the gas tax. The total swing in the budget was $19.4 billion in fiscal year 1982, $70.1 billion in fiscal year 1983, and $119 billion in fiscal year 1984.

At the same time, we put the Fed on a course of what I would call upper limit monetarism in which they shoot for the upper limits of their monetary growth targets. These are growth targets that are still being reduced year by year—5.5, 5, and 4.5 percent—but it is a twist toward easier policy. The maintaining of these growth rates in the face of fiscal restraint requires a good-sized drop in interest rates.

We also assumed that such a program of strict budget restraint would cause the expectations of the financial markets and wage earners for an even more slack economy and lower inflation. That heavy dose of fiscal restraint would be very welcome medicine to the financial markets and we lowered the expected rate of inflation in the model a little bit to reflect this assumption.

The result of this exercise, this move toward tighter fiscal restraint and easier money, did not much affect total growth of GNP over the next few years, but did result in a major decline of interest rates from 2 to 5 percentage points in the Treasury bill rate and from 1 to 2 percentage points in long-term rates; also the redressing of the imbalances of the current loose fiscal-tight money mix on the interest rate sensitive areas of the economy.

Business fixed investment in real terms is up a little bit. Automobile sales are up 600,000 units by 1984 and housing starts are up 0.61 million units by 1984. Overall, the inflation rate is a little better. The real economy doesn't change much, but the mix of the current policy approach is changed considerably and does relieve much of the stress that is going on in the economy now.

Now these numbers and these results are less important than the idea. I think it's absolutely critical at this time that the administration and Congress change this mix of policy which has brought us to the brink of very severe problems. I think that if the administration continues on the current course and we do legislate the kinds of policies that lead to the even $110 billion deficits, reactions of the financial markets will be very negative and those reactions are not irrational. Those reactions see through the numbers of the Reagan budget proposals for fiscal years 1983 and 1984 and recognize that you can't put in a net $400 billion of fiscal stimulus in 1983 to 1986 under the new Fed policy without having very, very high interest rates and all the stress that goes on in the interest rate sensitive areas. I think if we don't change the policy mix that we are taking some very great risks with our economy for the next few years and that the administration is taking a very big risk for its chances of reelection in 1984.

[The prepared statement of Mr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI*

I. Introduction and Summary

More than at any time since the Great Depression, the course of economic policy is determining the performance of the U.S. economy. Many new policies have been instituted in the last few years, including 1) the "easy fiscal-tight money" policy mix set by Reaganomics and the New Fed Policy; 2) a major shift in the role of the federal government vis-a-vis the private sector; 3) deregulation of the U.S. economy; 4) a more laissez-faire attitude toward mergers and acquisitions; and 5) new approaches in the setting of wages.

Are the new policies working? Certainly, with regard to the principal goal of reducing inflation, there has been impressive progress. In 1981, U.S. inflation rates dropped sharply and the price-wage-price spiral showed signs of a secular turn downward.[1] However, in the process of fighting inflation, other problems have been created. In particular, repeated clashes between the monetary restraint of the New Fed Policy, renewed growth of the economy, and large federal budget deficits have led to unprecedented levels of nominal and real interest rates. The results have been an increasingly severe recession, massive unemployment, chronic stagnation for the economy, severe financial strain and threats to the viability of many corporations, even greater federal budget deficits, and rates of inflation that are still unacceptable. It is probably fair to say that these new problems are bringing another crisis of confidence over the ability of the U.S. Government to deal effectively with the economy.

Table 1
Recent Behavior of Inflation in the U.S. Economy

	1973	1974	1975	1976	1977	1978	1979	1980	1981F
Consumer Price Index	8.3	12.2	7.4	5.1	6.7	9.8	12.7	12.5	9.5
Producers Price Index for Finished Goods	11.5	18.7	7.0	3.2	7.1	10.3	12.7	12.5	7.2
GNP Deflator	7.0	10.1	7.7	4.7	6.1	8.5	8.1	9.8	8.9

---

*Senior Vice President, Data Resources, Inc., Lexington, Massachusetts. Steven Blitz, Scott Lovestead, and Carol Zahka provided assistance in the preparation of this testimony.

[1] A. Sinai, "Contemporary U.S. Inflation: A Secular Turn?" presented at the Annual David Monroe Invited Speech, Kalamazoo College, Kalamazoo, Michigan, May 11, 1981.

Although it is much too early to expect the new policies to fully resolve the problems of the U.S. economy, a reevaluation and reexamination of them is appropriate to find changes that could help bring better results. The possibility that the new policies of Reaganomics and the Federal Reserve need to be readjusted or fine-tuned should be recognized without prejudice or negative reflection on the Administration or central bank. No radically new set of policies could possibly work smoothly in practice without some modification as developments unfold. Changes of policy in midcourse, if made sensibly and carefully, are a sign of strength and wisdom in policymaking, rather than of weakness. One thing is for sure, without adjustments now in the current thrust of policies, the U.S. economy runs the risk of a major collapse, unprecedented in the postwar period.

In this testimony, the current policy setting and outlook for the economy and financial markets is presented, some major issues in the outlook and the problems of the economy discussed, and evidence offered for the effects of changes to a "tighter fiscal and easier money" policy mix on the real economy, inflation, employment, interest rates, and capital formation. With the economy still deteriorating, a record level of joblessness fast approaching, unprecedented high levels of nominal and real interest rates for this stage of the business cycle, and the viability of so much of corporate America in question, there is a great need to reconsider the current direction of policies. In particular, the prospects and impacts of large federal budget deficits and the effects of policies to reduce the deficit are considered in simulations with the DRI Model of the U.S. Economy.

Briefly-

- The recession is increasing in severity, although the pace of the downturn is decelerating. Current DRI projections show another three to five months for the recession, with real GNP down 2½% in the first quarter after a near 6½% drop in 1981:4, then up only 0.6% during the second quarter. The unemployment rate will rise to 9.5%, which corresponds to 10.3 million unemployed, the highest number of jobless since the Great Depression. The bright spot is significant progress on inflation, forecast to fluctuate in a 5% to 8% range for the next year. A recovery in the economy should begin in the second quarter, gathering steam during the second half of the year from the second stage of personal income tax cuts, an end to inventory decumulation, improved housing sector activity, and increased military spending. Solid real economic growth of 4% to 6% is expected for the third and fourth quarters. However, the renewed growth in the economy, tax cut stimulus, and some reacceleration of inflation will clash with Federal Reserve policy, producing sizeable rises of interest rates and limiting the expansion. For 1983 and 1984, high interest rates will hold the growth of the economy to 4.1% and 3.5%, a considerably lower rate of expansion than in most postwar recoveries.

- The current recession, while projected to be of near average duration and depth relative to other postwar downturns, is nevertheless a dangerous one for the U.S. economy. As the second recession in two years, the current double-dip episode is without precedent. By now, the downturn is quite widespread, both across industries and geographical areas. Not only are the same interest-rate sensitive industries being battered as in the 1980 recession, but additional sectors and companies are being squeezed as well. Industries such as airlines, agriculture, agricultural machinery, autos and auto-related, building materials, construction, copper, forest and paper products, housing and homebuilding, lead and zinc, real estate, steel, railroad equipment and trucking are chronically recessed. Certain sectors of the economy including small business, state and local governments, autos, housing, and thrift institutions are scaling down operations to a permanently lower level of activity. Most areas of the country are now feeling the effects of the recession, including the previously immune regions such as New England and the Pacific Coast. A growing number of firms are on the danger list with sales and profits ever weaker, deteriorated balance sheets, still high interest rates sustaining punitive debt service burdens, and prohibitive cost structures.

Interest rates, both nominal and real, are forecast to remain at unprecedented levels for a recession-recovery episode. The high interest rate environment is a product of the "easy fiscal-tight monetary" mix of Reaganomics and the New Fed Policy with near $850 billion of personal and business tax cuts legislated for the next five years, $237 billion in higher military outlays, and only $579 billion of planned cuts in nondefense spending, at best. Short-term interest rates should fall further, however, given the recession and lower inflation rates, with the prime rate dropping to 13% by mid-year. The bond markets are due for another rally, reflecting the improving outlook for inflation. Subsequently, continuing volatility in the financial markets will keep nominal interest rates fluctuating in double-digit territory despite substantially lower rates of inflation. So will the federal budget deficit and prospective Treasury financing, factors that are now much more important to the determination of interest rates under the New Fed Policy. Money market rates are forecast to fluctuate between 10% and 17% and bond yields from 11½% to 16% for the next three years. The interest rate projections assume NIA federal budget deficits of $115.7 billion, $110.1 billion, and $103.3 billion in calendar 1982, 1983 and 1984.

The deceleration in the rate of inflation that occurred in 1981 will be sustained over the next few years, although with inflation still at a relatively high plateau compared with most of the postwar period. More than any other factor, tight money has been responsible for bringing inflation rates down. Current projections show inflation rates fluctuating between 5% and 8% over the next few years, held down by improvement in the speculative elements of inflation and a relatively large amount of slack in the labor markets. The core inflation rate should drop into the 6% to 7% range, held up by still high unit labor costs that prevent a further move downward to low single-digit rates of inflation.

For an even greater improvement on prices to occur, major reductions in wage inflation are necessary. The cost structures for many corporations have become prohibitive. Unit labor costs must come down in order for more competitive pricing in an environment of weak demands. Since productivity growth will not contribute much to an improvement in unit labor costs over the next year or so, the reductions must occur in wages. So far, there is room for optimism because of an apparent emerging new approach to wage settlements, manifested in new agreements for 55,000 oil, chemical, and atomic workers, and between the Teamsters union and trucking industry. It will also be necessary to hold real economic growth to a moderate pace to encourage further reductions in wage and price inflation. Methods for achieving this could be solely through monetary restraint, by tightening fiscal policy, or through the institution of tax-based incomes policies (TIP). Of these choices, the simplest and most productive is to move the budget to a more restrictive stance. The next best approach would be an incentive-based TIP.

The NIA federal budget deficit is forecast at $108.3 billion in FY82, $111.9 billion in FY83, and $110.0 billion in FY84. The unified budget deficit is expected to be $108.1 billion, $100.7 billion, and $89.8 billion. These will be record deficits, although not so relative to nominal GNP. In order to achieve these figures, DRI assumes that the Reagan Administration proposes increases in the gasoline tax for FY83 (4 cents to 8 cents a gallon, $4 billion of revenue), new excise taxes on liquor and tobacco ($8 billion of revenue in FY83 and $11 billion in FY84), and a "windfall profits" tax to go along with accelerated deregulation of natural gas prices (January 1, 1983, $3 billion of revenue in 1983 and $6 billion in 1984). Military spending, in real terms, is assumed to rise at a 6% annual rate, somewhat less than the 7% desired by the Reagan Administration. Nondefense spending is cut $11.4 billion in FY83 and $23.5 billion in FY84. Grants-in-aid to state and local governments are reduced $27.3 billion in FY83 and $39.9 billion for FY84. Without these adjustments, the ex-post NIA deficits would be a huge $120.3 billion, $152.0 billion, and $188.9 billion for the next three fiscal years. Interest rates would be at least 100 to 400 basis points higher than currently forecasted, depending on the impact of the deficits on inflation expectations. The economy would show somewhat higher growth and less unemployment, but at the expense of housing and business capital formation.

The prospects of large budget deficits are creating a major problem for economic policy, the financial markets, the Federal Reserve, and the economy. A quick, but probably rational, discounting of the effects from the fiscal stimulus legislated for 1983 and 1984 and restraint of monetary policy is keeping both short- and long-term interest rates high. The high interest rates restrain real economic growth and increase unemployment, but inflation rates lag before turning significantly lower. The resulting higher unemployment and slow economic growth bring less tax receipts to the federal government, aggrevating the deficit. So do the higher interest rates and lower inflation rates. The still higher deficits raise Treasury financing needs, pressing more on financial markets to create yet further problems in a seemingly unending positive feedback of effects.

The most important change that must be made in current policy is a switch to a "tighter fiscal-easier monetary" policy. Reductions in spending and increases of taxes would restrain growth of the real economy, reduce inflation, and limit the demands for funds by the federal government. By itself, the tighter fiscal policy could bring a collapse to an economy that is already in recession. But an offset of easier monetary policy could prevent much of a decline without violating the monetary growth targets of the Federal Reserve. Indeed, such a policy mix would result in substantially lower interest rates, increased housing activity, more business capital formation, and might more than offset the negative impacts on the overall economy from the tighter fiscal policy. The federal budget would even benefit from lower interest charges on the government debt. The imbalances for the economy of a tight monetary policy and high interest rates would be mitigated, with net benefits and less financial strain on individual industries and firms as a result.

Simulations with the DRI model show that a program designed to reduce the deficit approximately $119 billion by fiscal year 1984, if accompanied by monetary growth at the upper limits of Federal Reserve targets, would help the economy perform better on all counts. Assuming a quick improvement in the expected rate of inflation from the announcement of the fiscal restraint, interest rates would decline by one to five percentage points, housing starts rise by 117,000 to 610,000 units, and business fixed investment increase $1.0 billion to $3.4 billion over the next few years. Other interest rate sensitive areas, such as auto sales, also would do better. The financial squeeze on nonfinancial corporations would be eased and the threat of bankruptcy and failure would be minimized. The thrift industry would be revitalized. No worsening of inflation would occur so long as the Federal Reserve did not exceed its new, lower targeted growth rates. The particular mix of policies to bring about the $119 billion ex-ante improvement in the Federal budget is less important than the magnitude. With this program of fiscal restraint, the resulting ex-post NIA deficits would be $97.4 billion, $63.2 billion, and $38.1 billion in 1982, 1983 and 1984, respectively, exceeding the proposed changes because of increased real growth and lower interest rates in a substantial improvement from what now appears to be in prospect.

II. The Economic Outlook

The economy currently is in a relatively severe recession. The drying up of orders in the fourth quarter, a large 2.1% drop of industrial production during December, rising inventory-sales ratios; a jump in the unemployment rate to 8.9%, and only an 0.2% rise for personal income confirm that a broad-based decline is in process throughout much of the U.S. economy. Survey data on consumer sentiment, business plans for capital outlays as published by the Department of Commerce, and the monthly report of the National Association of Purchasing Agents all indicate that the downturn will continue in the early part of this year. A somewhat higher rate of auto sales in early January, flat retail sales in real terms, a slight upturn in housing activity, and lesser declines in the leading indicators do suggest that the pace of deceleration has slowed. But with production, employment, and inventories to be cut further and negative impacts on income from rising unemployment, it is clear the bottom of the recession has not yet been reached.

The situation appears quite bleak, with essentially no growth in the U.S. economy since 1979. Industrial production is well below that of early 1979. Retail sales, in real terms, are far under the 1979 figures. Auto sales are 4.4 million units below the peak that was reached in 1979. Housing starts are almost 1.0 million units lower than the June 1979 peak. And the factory utilization rate for All Manufacturing is only 72.9% compared with 87.2% in March 1979.

Chart 1
Federal Reserve Industrial Production
Index - Total (SA, 1967=1.0)

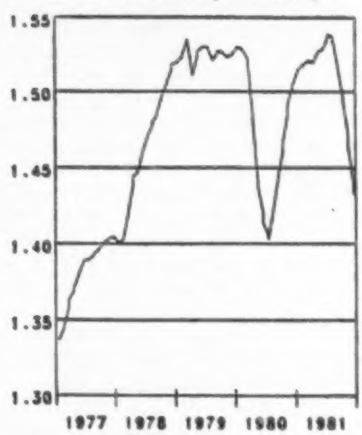
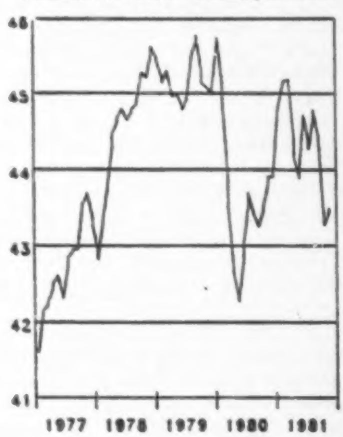


Chart 2
Retail Sales
(Billions of 1972 Dollars, SAAR)



Since early 1979, real business fixed investment has declined at an annual rate of 0.6% per quarter; real GNP is up only 0.3%; industrial production has declined by 1.5% a quarter; and employment has grown at only a compound annual rate of 0.6%. With the unemployment rate at 8.9% and headed higher, a 72.9% rate of capacity utilization, and the gap between potential and actual real GNP estimated to be a large $127.3 billion, there can be no doubt that the U.S. economy is in a chronic state of recession.

Table 2
U.S. Economic Performance Since 1979
(Percent change, cpd. annual growth rates since 1979:1)

Real GNP	0.3
Implicit GNP Deflator	8.9
Retail Sales (1972 $'s)	-0.7
Industrial Production	-1.5
Business Fixed Investment (1972 $'s)	-0.6
Employment (Household Survey)	0.6

Why is the U.S. economy in the current situation? The critical determinant has been economic policy. In particular, a tight monetary policy at first squeezed a limited number of sectors such as autos, housing, and state and local governments but then after over two years of implementation impacted across a broader base. At the same time, the tax and spending programs of Reaganomics legislated this past summer provided no stimulus. As Table 3 shows, the real impacts of the Reagan fiscal program are programmed to occur from 1983 to 1986 when a cumulative $401 billion of net fiscal stimulus will be injected into the economy (bottom-line). The distribution of the stimulus is quite uneven, much less in the early years of the Reagan Administration and much greater in the later years. Indeed, even more stimulus than is indicated could occur since it is uncertain whether the assumed spending cuts can be achieved. It is this prospect that has added to the near-term problems of the U.S. economy, shattering the financial markets this past summer and in recent weeks as the bond markets discount now the potential inflationary impacts of the loose fiscal policy and the congestion from so heavy a volume of Treasury financing.

Table 3
"Reaganomics" - The Budget Program as of Mid-Summer
"5-10-10" Personal Income Tax Reductions, "15-10-5-3" Accelerated Capital Recovery for Business and Increased Tax Credits, Federal Spending Cuts from $4.8 Billion in FY81 to $160.8 Billion in FY86)*

	1981	1982	1983	1984	1985	1986
			Outlays - Fiscal Years ($ Bils.)			
Existing Budget Status						
Current policy base	665.5	729.7	792.1	849.0	911.4	972.8
Added defense funds	0.5	12.3	34.1	43.3	65.8	81.4
Current policy base with adequate defense	666.0	742.0	826.2	892.3	977.2	1054.2
President's Budget Savings Proposals						
Actions:						
Budget outlay reductions	-6.4	-35.2	-67.2	-81.2	-92.8	-102.7
Nondefense increases	1.6	1.2	1.8	1.9	1.8	1.7
Budget savings to be proposed	-	-3.2	-32.1	-54.5	-51.6	-58.1
Proposed Spending Ceiling	661.2	704.8	728.7	758.5	834.6	895.1
			Receipts - Fiscal Year ($ Bils.)			
Current Law Receipts	608.5	700.1	798.5	908.8	1039.6	1191.0
Policy Changes:						
Individual income tax reductions	-	-26.9	-71.1	-114.7	-148.2	-196.1
Business tax cuts	-1.6	-10.7	-18.6	-28.3	-39.3	-54.5
Energy tax provisions	-	-1.3	-1.7	-2.2	-2.8	-3.6
Savings incentive provisions	-	-0.3	-1.8	-4.2	-5.7	-8.4
Estate and gift tax provisions	-	-0.2	-2.1	-3.2	-4.2	-5.6
Tax shelter provisions	0.04	0.6	0.3	0.3	0.2	0.2
Administrative provisions	-	1.2	2.0	1.9	0.7	0.6
Miscellaneous provisions	-	-0.09	0.3	0.6	0.06	-0.3
Subtotal	-1.6	-37.7	-92.7	-149.8	-199.2	-267.7
Receipts With New Policies	605.6	662.4	705.8	759.0	840.4	923.3
Net (Revenue Loss Less Net Budget Savings)**	-2.7	12.4	29.3	59.3	122.4	190.0

*Before feedback and based on Administration economic assumptions. Sources: The White House, Summary Fact Sheet, February 18, 1981; 1982 Budget Revised, March 20, 1981; Office of Management and Budget, Mid-Session Review of the 1982 Budget; Joint Committee on Taxation.

**Net budget savings is budget outlay reductions plus budget savings to be proposed less added defense funds and nondefense increases.

The current DRI forecast shows the recession continuing into spring, then restrained expansion with ebbs and flows in real economic activity reflecting the new volatility of the U.S. economy. A slow process of disinflation is forecast to occur, with inflation rates in a 5% to 7% range during the first half of 1982, reflecting the cyclical impact of the recession. Thereafter, inflation rates fluctuate considerably but are lower, on average, for the next few years. There is a sharp rise in joblessness over the next six months, with the unemployment rate possibly exceeding 9½% some month this spring. The jobless rolls are likely to rise to over 10 million persons before the recovery in the second half begins to reduce the unemployment rate. Interest rates should resume declining after the current bulge in the money supply is absorbed, reflecting very positive fundamentals for the money and capital markets, viz., a weak economy, lower inflation rates, reduced demands for credit, and increased saving by the private sector. Both the auto and housing sectors probably have bottomed out, but will exhibit only modest improvements for the rest of this year.

Table 4
Data Resources Forecast of the U.S. Economy - INTERIM011582

	1981		1982				1983		Years				
	III	IV	I	II	III	IV	I	II	1980	1981	1982	1983	1984
GNP and Its Components Billions of Dollars - SAAR													
Total Consumption	1883.9	1911.2	1947.5	1990.2	2043.9	2095.9	2155.5	2213.7	1672.7	1858.6	2019.4	2240.2	2482.2
Nonres. Fixed Investment	335.1	331.1	331.5	334.9	344.0	354.1	366.0	379.7	295.9	326.7	341.1	386.5	443.0
Res. Fixed Investment	100.5	97.0	96.3	107.1	119.4	131.0	143.2	153.9	105.3	106.2	113.4	157.3	186.4
Inventory Investment	27.5	13.9	0.4	-9.2	2.4	13.8	17.1	16.7	-5.9	17.3	1.8	18.3	25.4
Net Exports	29.3	20.8	17.9	14.8	13.9	12.9	11.7	13.9	23.3	25.0	14.9	15.3	20.4
Federal Purchases	226.4	241.9	245.5	250.4	256.4	272.9	275.5	278.6	198.9	227.4	256.3	284.5	315.3
State and Local Govt. Purchases	362.5	366.3	369.8	373.9	378.9	385.2	392.3	399.7	335.8	360.4	377.0	403.6	436.2
Gross National Product	2965.0	2982.2	3008.9	3062.2	3158.9	3265.9	3361.4	3456.2	2626.1	2921.5	3124.0	3505.7	3888.8
Real GNP (1972 Dollars)	1515.8	1490.8	1481.5	1483.7	1504.2	1521.5	1537.0	1552.2	1480.7	1508.3	1497.7	1559.6	1614.8
Prices and Wages - Annual Rates of Change													
Implicit Price Deflator	9.9	9.5	6.1	6.5	7.0	8.2	7.9	7.7	9.0	9.2	7.5	7.7	7.2
CPI - All Urban Consumers	11.9	7.7	6.2	6.5	7.6	7.9	8.6	8.0	13.5	10.3	7.6	7.9	7.6
Producer Price Index - Finished Goods	4.0	4.6	4.8	6.1	6.6	7.8	8.3	8.1	13.5	9.2	5.6	7.7	8.2
Compensation per Hour	9.3	8.2	7.9	7.9	8.3	8.7	8.3	8.1	9.9	10.0	8.3	8.2	8.3
Core Inflation	8.7	8.3	7.8	7.5	7.1	7.0	6.9	6.8	9.2	8.8	7.4	6.8	6.9
Production and Other Key Measures													
Industrial Production (1967=1.000)	1.531	1.464	1.428	1.438	1.467	1.500	1.533	1.563	1.470	1.508	1.458	1.573	1.658
Annual Rate of Change	1.5	-16.3	-9.5	2.9	8.2	9.5	8.9	8.0	-3.6	2.7	-3.4	7.8	5.4
Housing Starts (Mil. Units)	0.968	0.871	0.977	1.180	1.298	1.469	1.553	1.617	1.303	1.102	1.231	1.628	1.805
Retail Unit Car Sales (Mil. Units)	9.1	7.4	8.1	8.5	9.4	9.7	9.8	10.0	9.0	8.6	8.9	10.0	10.4
Unemployment Rate (%)	7.2	8.4	9.1	9.4	9.2	9.0	8.7	8.4	7.1	7.6	9.2	8.3	7.6
Federal Budget Surplus (NIA)	-55.7	-95.2	-103.4	-103.7	-130.9	-124.8	-107.2	-94.1	-61.2	-61.2	-115.7	-110.1	-103.3
Money and Interest Rates													
Money Supply (M1)	431.6	437.7	444.1	445.6	452.6	456.3	462.0	467.8	417.0	437.7	456.3	478.9	500.4
Annual Rate of Change	0.4	5.8	6.0	1.3	6.4	3.3	5.1	5.1	7.3	5.0	4.3	5.0	4.5
New AA Corp. Utility Rate (%)	17.03	16.61	15.25	14.51	14.17	15.50	14.84	13.39	13.14	16.21	14.86	13.55	12.38
New High-Grade Corp. Bond Rate (%)	15.99	15.49	14.75	13.61	13.77	14.77	14.19	12.78	12.47	15.01	14.22	12.95	11.83
Federal Funds Rate (%)	17.58	13.57	12.38	11.01	13.39	14.62	13.85	12.71	13.36	16.37	12.85	13.00	11.44
Prime Rate (%)	20.32	16.99	15.32	13.81	14.92	15.46	15.35	15.24	15.27	18.86	14.88	15.04	13.59
Incomes - Billions of Dollars													
Personal Income	2441.7	2482.0	2523.9	2570.1	2648.5	2730.1	2793.9	2855.1	2160.3	2403.0	2618.1	2894.5	3181.8
Real Disposable Income (%Ch)	2.6	1.3	0.0	0.6	10.9	4.4	2.7	1.4	0.7	2.1	2.4	4.3	3.3
Saving Rate (%)	5.2	6.0	5.3	5.0	6.5	6.5	6.3	5.9	5.6	5.3	5.9	6.5	6.8
Profits Before Tax	234.4	197.7	179.4	185.2	206.0	226.8	232.0	246.7	245.5	229.5	199.3	253.3	281.1
Profits After Tax	156.3	134.5	124.5	128.3	141.3	154.3	159.7	169.3	163.2	153.2	137.1	173.6	197.3
Company Profits	112.5	109.2	104.3	103.9	107.2	111.2	114.9	117.7	106.0	109.2	106.7	120.0	136.9
Four-Qtr. Percent Change	10.6	0.7	-2.2	-4.2	-4.7	1.8	10.1	13.3	0.2	3.0	-2.3	12.6	14.0
Composition of Real GNP - Annual Rates of Change													
Gross National Product	1.4	-4.4	-2.5	0.6	5.6	4.7	4.1	4.0	-0.2	1.9	-0.7	4.1	3.5
Final Sales	0.3	-4.3	-0.8	1.8	4.2	3.4	3.8	4.1	0.7	1.1	-0.2	3.7	3.4
Total Consumption	3.3	-2.0	0.9	2.4	4.1	3.1	3.7	4.1	0.5	2.6	1.3	3.6	3.1
Nonres. Fixed Investment	7.1	-11.7	-5.9	-2.3	4.6	4.8	5.5	6.8	-3.0	1.9	-2.7	5.1	6.5
Equipment	6.3	-16.4	-5.3	0.0	10.1	9.1	7.5	8.5	-4.2	0.7	-2.5	7.7	7.0
Nonres. Construction	8.4	-0.6	-7.1	-6.9	-6.4	-4.6	0.9	2.8	-0.1	4.8	-3.0	-0.6	5.2
Res. Fixed Investment	-36.3	-17.3	-9.7	40.8	41.2	31.7	29.3	21.3	-18.6	-5.4	-0.9	28.5	9.5
Exports	-3.4	-5.2	-3.6	-0.7	3.4	5.7	6.4	7.0	9.6	-0.3	-1.9	5.7	6.8
Imports	5.3	5.9	-1.4	3.4	7.1	7.6	6.2	6.8	-0.1	6.0	4.2	6.5	6.0
Federal Government	3.4	2.6	2.1	2.8	6.6	0.8	-2.2	-1.3	6.4	1.7	2.2	0.6	1.0
State and Local Governments	-4.1	-3.5	-3.5	-2.8	-2.2	-1.1	-0.5	-0.4	1.0	-1.1	-3.2	-0.8	0.5

Table 5
U.S. Economic Prospects: INTERIM011582

	Actual 1980	1981	1982	Estimate 1983	1984	1985	1986
Major economic indicators:							
Gross national product (percent change, fourth quarter over fourth quarter):							
Current dollars	9.4	9.2	9.5	11.8	10.7	13.6	10.8
Constant (1972) dollars	-0.3	0.3	2.1	3.9	3.4	4.9	3.3
GNP deflator (percent change, fourth quarter over fourth quarter)	9.3	8.9	6.9	7.8	6.9	8.5	7.2
Consumer Price Index (percent change, fourth quarter over fourth quarter) 1/	12.5	9.6	7.0	8.0	7.5	7.9	7.6
Unemployment rate (percent, fourth quarter)	7.5	8.4	9.0	7.9	7.5	6.8	6.5
Annual economic assumptions:							
Gross national product:							
Current dollars:							
Amount	2626	2922	3124	3506	3889	4406	4904
Percent change, year over year	8.8	11.2	6.9	12.2	10.9	13.3	11.3
Constant (1972) dollars:							
Amount	1481	1508	1498	1560	1616	1691	1752
Percent change, year over year	-0.2	1.8	-0.7	4.1	3.5	4.7	3.7
Incomes:							
Personal income	2160	2403	2618	2885	3182	3573	3951
Wages and salaries	1344	1482	1580	1746	1914	2165	2396
Corporate profits 2/	246	230	190	253	281	348	379
Price level:							
GNP deflator:							
Level (1972=100), annual average	177.4	193.7	208.3	224.3	240.5	260.6	279.7
Percent change, year over year	9.0	9.2	7.5	7.7	7.2	8.4	7.3
Consumer Price Index 1/:							
Level (1967=100), annual average	247.0	272.4	293.0	316.3	340.3	367.0	394.7
Percent change, year over year	13.5	10.3	7.6	7.9	7.6	7.8	7.6
Unemployment rate:							
Total, annual average	7.1	7.6	9.2	8.3	7.6	7.0	6.6
Federal pay raise, October (percent) 3/:							
Civilian	9.1	4.8	7.0	7.0	7.0	6.4	6.0
Military	11.7	14.3	8.9	7.9	7.0	6.4	6.0
Interest rate, 90-day Treasury bills (percent) 4/	11.4	14.0	11.7	11.6	10.9	9.9	10.4
Deficit (NIA, bils. of $'s).	-61.2	-61.2	-115.7	-110.1	-103.3	-61.0	-66.6

1/ CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs.

2/ Excludes the direct accounting effect of the Administration's depreciation proposal on business income, although all categories of economic assumptions do reflect the economic impact of this proposal.

3/ Pay raises become effective in October of each year -- the first month of the fiscal year. Thus, the October 1981 pay raise will set new pay scales that will be in effect during fiscal year 1982.

4/ Average rate on new issues within period.

The current recession is forecast to be near the average for the postwar period in length and depth. The trough is forecast to occur in May, with the peak-to-trough decline in real GNP at 2.8%. The 11-month duration for the recession and decline from peak-to-trough are quite close to the average 10.1 month length for seven other postwar recessions and the 2.4% average decline in real GNP. Industrial production is forecast to drop 8%, compared with the average 11.7% decline for the other recessions.

Table 6
Recessions in the Postwar Period
(% chg., cpd. annual rates)

		Real Economic Growth (%)				Consumer Price Index (%)		
Peak	Trough	Duration Months	At Peak	At Trough	Over Duration	At Peak	At Trough	Over Duration
November 1948	October 1949	11	4.1	-3.2	-1.4	-7.0	-4.8	-2.3
July 1953	May 1954	10	-2.5	-1.6	-3.5	-0.1	3.2	0.7
August 1957	April 1958	8	2.1	2.7	-3.6	3.9	2.0	3.5
April 1960	February 1961	10	-1.2	3.1	-0.1	5.9	0.8	1.2
December 1969	November 1970	11	-2.3	-3.1	-0.1	7.7	5.2	5.5
November 1973	March 1975	16	3.3	-8.2	-3.9	11.1	4.7	11.0
February 1980	July 1980	5	3.1	2.4	-4.0	16.5	1.0	10.3
July 1981	May 1982F	11F	1.4	0.6F	-2.8F	15.2	6.5F	6.8F

		Unemployment Rate (%)				Industrial Production (%)		
Peak	Trough	Duration Months	At Peak	At Trough	Over Duration	At Peak	At Trough	Over Duration
November 1948	October 1949	11	3.8	7.9	4.1	-16.0	-35.6	-9.3
July 1953	May 1954	10	2.6	5.9	3.3	16.2	7.3	-10.6
August 1957	April 1958	8	4.1	7.4	3.3	0.0	-17.8	-18.4
April 1960	February 1961	10	5.2	6.9	1.7	-10.1	-1.9	-7.3
December 1969	November 1970	11	3.5	5.9	2.4	-2.1	-6.6	-6.3
November 1973	March 1975	16	4.8	8.5	3.7	1.8	-10.1	-11.6
February 1980	July 1980	5	6.2	7.6	1.4	-1.6	-8.9	-18.5
July 1981	May 1982F	11F	7.0	9.4F	2.4F	8.1	2.9F	-8.0F

F = DRI Forecast

Summary Statistics
(7 Recessions in Postwar Period Prior to 1981)

Length (mos.)	Avg. Med.	10.1 10.0	
Depth (% chg.)	Avg. Med	-11.7 -10.6	Industrial Production
Depth (% chg.)	Avg. Med.	-2.4 -3.5	Real GNP

Despite the average appearance of the recession, it is a particularly "dangerous" one for the economy--the second dip of a "double-dip" episode with big downside risks still remaining. Most of the risks center on the role of monetary restraint in any new upturn and the potential clash between progressively lower targets for monetary growth and growth in nominal GNP. Under the New Fed Policy, renewed growth in nominal GNP, rises in credit demands, and increases for the monetary aggregates can automatically bring substantial rises of nominal and real interest rates. In the new environment, quick responses by the central bank to above targeted monetary growth and fiscal stimulus make a high interest rate environment inevitable with far-reaching effects on the economy. Thus, the possibility exists that no expansion can be sustained unless inflation rates drop by more than expected, the central bank relents on its policy of restraint, or the fiscal stimulus of Reaganomics is limited. Such was the case for the expansion of 1980, again in 1981, and already is possible now in 1982 with the recent surge in monetary growth.

Table 7
Economic Outlook and Risks
A Comparison of Alternatives: Annual Rates of Growth
(Percent)

	INTERIM011582 (Prob.=0.55)				OPTIM (Prob.=.10)				DEEPRECESS (Prob.=0.15)				STAGFLATION (Prob.=0.20)			
	1981	1982	1983	1984	1981	1982	1983	1984	1981	1982	1983	1984	1981	1982	1983	1984
Real GNP	1.9	-0.7	4.1	3.5	1.9	0.8	5.2	4.5	1.7	-1.9	6.0	4.9	1.9	-0.7	0.8	2.0
Final Sales	1.1	-0.2	3.7	3.4	1.2	1.1	4.8	4.4	1.1	-1.2	5.3	4.7	1.2	-0.2	0.9	1.9
Consumption	2.6	1.3	3.6	3.1	2.5	2.1	4.4	3.9	2.4	0.2	5.2	4.3	2.6	1.3	1.4	2.2
Nonres. Fixed Invest.	1.9	-2.7	5.1	6.5	2.4	2.4	8.9	9.1	1.6	-5.9	9.9	8.7	1.9	-1.4	0.0	1.8
Prod. Durable Equip.	0.7	-2.5	7.7	7.0	1.4	3.7	10.1	9.3	0.2	-6.2	12.2	10.1	0.7	-1.4	1.8	3.1
Nonres. Construction	4.8	-3.0	-0.6	5.2	4.8	-0.5	6.1	8.7	4.6	-5.3	4.7	5.3	4.8	-1.3	-3.8	-1.4
Federal Gov't. Purchases	1.7	2.2	0.6	1.0	1.3	0.4	-1.2	0.7	1.7	2.1	-0.3	1.3	1.7	1.3	-1.8	-0.7
State, Local Gov't. Purch.	-1.1	-3.2	-0.8	0.5	-1.1	-2.4	-0.2	1.0	-1.1	-2.9	-1.1	1.0	-1.1	-3.3	-1.2	-0.4
Exports	-0.3	-1.9	5.7	6.8	-0.2	-0.1	6.2	6.8	-0.2	-1.7	4.4	6.6	-0.3	-1.7	5.6	5.6
Imports	6.0	4.2	6.5	6.0	6.1	5.5	7.3	6.5	5.8	1.9	8.2	6.6	6.0	4.6	3.9	4.8
Prices and Wages																
Consumer Price Index	10.3	7.6	7.9	7.6	10.3	7.8	7.1	6.4	10.0	5.7	6.2	5.6	10.3	8.6	9.0	8.5
Core Inflation	8.8	7.4	6.8	6.9	8.8	7.3	6.6	6.4	8.8	7.2	6.1	5.9	8.8	7.4	7.2	7.8
Implicit Price Deflator	9.2	7.5	7.7	7.2	9.2	7.7	7.4	6.5	9.1	6.9	6.7	5.8	9.2	8.1	8.7	8.3
Compensation Per Hour	10.0	8.3	8.2	8.3	10.1	8.6	8.3	7.9	10.0	7.6	6.7	6.4	10.1	9.8	9.3	9.6
Prod. Prices Finished Gds.	9.2	5.6	7.7	8.2	9.2	5.8	7.6	7.5	9.2	5.5	6.3	5.5	9.2	6.2	8.0	9.3
Interest Rates and Other Key Measures																
Prime Rate (%)	18.86	14.88	15.04	13.59	18.86	14.15	13.77	12.16	18.71	10.98	10.97	9.96	18.86	15.60	16.86	17.16
New High-Gr. Corp. Bonds	15.01	14.22	12.95	11.83	15.02	13.49	12.47	10.76	14.74	10.63	10.82	10.24	15.02	15.31	16.09	15.24
Housing Starts (Mil.)	1.1	1.2	1.6	1.8	1.1	1.4	1.9	2.1	1.1	1.1	1.8	2.2	1.1	1.1	1.1	1.2
Retail Unit Car Sales (Mil.)	8.6	8.9	10.0	10.4	8.6	9.4	10.8	11.4	8.6	8.2	10.0	10.8	8.6	8.7	8.5	8.7
Saving Rate (%)	5.30	5.85	6.55	6.82	5.20	5.62	6.25	6.50	5.42	6.62	6.77	6.73	5.30	6.16	7.41	8.10
Real Disp. Income (SCH)	2.1	2.4	4.3	3.3	2.0	2.6	5.1	4.2	2.1	1.5	5.3	4.4	2.1	2.3	2.7	2.9
Profits (DRI, SCH)	3.0	-2.3	12.6	14.0	3.3	1.9	14.1	14.5	2.6	-6.1	17.4	16.1	3.1	-1.6	3.9	11.2

The probability of a deep recession or continued aborted attempts at economic recovery is assessed by DRI to be a high 35% and is reflected in the alternative scenarios, "Deep Recession" and "Stagflation." In Stagflation, inflation rates remain high, monetary growth accelerates rapidly later this year, and the congestion of Treasury financing pushes interest rates to new record levels, resulting in another year of stagnation during 1983. Of course, the higher interest rates and slow growth of the economy also hurt tax receipts and bring automatic increases in federal government spending, thus worsening the deficit rather than making it better. The risks to unemployment in this scenario are quite great, with a 10% unemployment rate within the realm of possibility some time in 1982 because of the weak economic behavior.

The danger of the current recession, however, lies in more than just the possibility that any recovery will be aborted by the New Fed Policy. Already, the recession has become very broad-based; both geographically and across sectors, industries, and firms. Few areas are now escaping the impacts of this second recession in two years, which was originally concentrated in the Midwest, East South Central, and East North Central regions. Even New England, the Pacific Coast, and Middle Atlantic regions are now being impacted. The chronic stagnation of the U.S. economy since 1979 makes it difficult for any area in the country to escape unscathed.

Table 8
Percent Change in Manufacturing Employment in the U.S. - By Region During Recent and Current Recessions

Region	1974-1975 Recession Swing % Decline	Rank	1980 Swing % Decline	Rank	1981 Forecast Swing % Decline	Rank	1982 Forecast Swing % Decline	Rank
Mountain	-8.7	3	-1.1	2	3.6	1	5.5	1
West South Central	-5.8	1	1.0	1	2.2	2	3.6	3
New England	-11.6	5	-1.5	3	-0.1	9	2.6	7
Pacific	-7.7	2	-2.5	5	0.9	7	4.2	2
West North Central	-9.6	4	-6.6	9	1.7	3	3.1	4
South Atlantic	-12.4	7	-1.7	4	1.0	5	3.1	5
East South Central	-13.6	8	-4.7	7	1.6	4	2.8	6
Middle Atlantic	-11.9	6	-3.8	6	0.2	8	1.3	9
East North Central	-13.9	9	-6.3	8	0.9	6	1.7	8

Table 9
Recession Impacts by Sector and Industry (Percent Change)*

	1980	1981	1982	1983
Economy:				
Corporate Profits Before Tax	-3.8	-6.5	-13.2	27.1
Corporate Profits After-Tax	-2.7	-6.1	-10.5	26.8
Company Profits	0.2	3.0	-2.3	12.6
Sector:				
Financial	1.4	-7.0	13.4	22.7
Utilities and Communications	9.6	13.1	5.8	16.0
Specialty Machinery	-4.7	10.5	3.9	29.6
Food and Beverages	10.5	10.5	2.7	16.3
Consumer-Household	12.5	3.2	1.6	21.0
Technology Related	12.9	-2.1	1.5	30.9
Miscellaneous Manufacturing	7.8	2.6	0.3	21.3
Miscellaneous Services	4.2	4.9	0.2	24.4
Oil Related	14.3	-11.6	-1.4	21.2
Retail Stores	-7.0	4.6	-3.2	22.5
Primary Processing Manufacturing	-1.4	3.7	-11.8	28.8
Construction Related	-22.3	-21.9	-16.2	75.4
Metals and Mining	14.7	-41.4	-18.3	98.7
Auto Related	NM	79.4	NM	121.6
Transportation	NM	74.8	NM	195.6
Industry:				
Financial				
Small Loans	-0.7	-40.1	14.3	29.2
Banks	7.8	3.7	7.9	17.5
Savings & Loans	-57.5	NM	NM	1,042.0
Utilities and Communications				
Gas	13.1	21.8	7.1	13.0
Telecommunications	6.0	10.4	5.8	16.7
Electric Companies	14.4	14.3	5.2	15.9
Specialty Machinery				
Agricultural Machinery	NM	-246.4	85.0	NM
Machinery & Services - Oil Well	33.5	33.8	7.1	29.6
Diversified Machinery	12.3	9.2	-6.4	26.1
Industrial Machinery	5.2	2.2	-8.2	35.7
Machine Tools	1.8	-4.3	-13.0	38.8
Food and Beverages				
Food - Packaged	8.3	4.7	5.0	16.5
Beverages - Distillers	5.7	36.1	4.5	11.9
Beverages - Soft Drinks	3.5	8.3	3.8	19.7
Foods - Canned	12.8	9.0	3.0	16.4
Foods - Dairy Products	10.0	1.7	-0.4	19.9
Foods - Meat Packing	24.3	-7.9	0.9	18.0
Consumer - Household				
Cosmetics	5.1	-2.4	12.9	18.2
Medical Supplies & Equipments	12.2	8.4	7.9	26.5
Drugs	11.9	4.2	5.4	19.0
Tobacco	19.4	13.0	3.4	15.6
Soaps	9.1	1.2	2.6	19.9

*Sector and Industry Ranked Relative to 1982
Source: DRI Industry Financial Service

With the fallout of the recession now widespread geographically and across sectors, an even longer and deeper recession could prove devastating for many industries. As shown in Table 10, numerous industries would be sensitive to a further, more pronounced weakness of the economy as depicted in the "Deep Recession" contingency.

Table 10
Classification of Industries by Degree of Susceptibility to a Deep Recession in 1982: Ranked on Earnings Growth

		(1) BASELINE 1981	(2) BASELINE 1982	(3) DEEP RECESSION 1982	(4) DIFF (3)-(2)	
1.	SHOES	5.4	4.4	3.2	-1.2	Group 1: Recession Resistant Industries
2.	BEVERAGES-BREWERS	7.0	6.4	4.9	-1.5	
3.	TEXTILE APPAREL	-8.8	5.7	4.1	-1.6	
4.	BEVERAGES-DISTILLERS	27.3	4.8	3.2	-1.6	
5.	CONFECTIONERY	15.8	5.6	3.9	-1.7	
6.	FOODS-CORN REFINERS	17.0	3.7	2.0	-1.7	
7.	BAKERS-BISCUIT, CAKE & BREAD BAKERS	9.0	7.1	5.1	-2.0	
8.	FOODS-PACKAGED	9.4	5.4	3.4	-2.0	
9.	FOODS-CANNED	10.0	6.7	4.6	-2.1	
10.	FOODS-MEAT PACKING	-5.8	6.7	4.5	-2.2	
11.	FOODS-DAIRY PRODUCTS	8.4	3.2	0.9	-2.3	
12.	TOBACCO	13.0	7.8	5.5	-2.3	
13.	BUILDING MATERIALS - CEMENT	-18.1	-1.7	-4.1	-2.4	
14.	TEXTILE PRODUCTS	-3.5	2.8	0.4	-2.4	
15.	BEVERAGES-SOFT DRINKS	9.0	5.8	3.4	-2.4	
16.	RESTAURANTS	9.5	5.5	2.8	-2.7	
17.	OFF-SHORE DRILLING	40.7	11.7	8.8	-2.9	
18.	GAS	21.4	9.0	6.1	-2.9	
19.	MOTEL & HOTEL	11.3	11.6	8.5	-3.1	Group 2: Industries that have Average Vulnerability to the Projected Recession
20.	COSMETICS	4.2	8.2	5.1	-3.1	
21.	DRUGS	6.2	8.5	5.3	-3.2	
22.	SOAPS	3.8	5.0	1.7	-3.3	
23.	REAL ESTATE & HOMEBUILDING	-24.6	5.0	1.7	-3.3	
24.	TELECOMMUNICATIONS	9.0	8.0	4.7	-3.3	
25.	ELECTRIC COMPANIES	9.9	7.8	4.3	-3.5	
26.	VENDING MACHINES & FOOD SERVICES	-6.1	2.1	-1.4	-3.5	
27.	POLLUTION CONTROL EQUIPMENT	-54.5	5.6	1.9	-3.7	
28.	MACHINERY & SERVICES - OIL WELL	22.6	9.9	6.1	-3.8	
29.	OIL-CRUDE PRODUCERS	-6.3	4.8	0.9	-3.9	
30.	RETAIL DEPARTMENT STORES	8.9	5.7	1.7	-4.0	
31.	RETAIL STORES-DRUG STORE CHAINS	21.0	9.7	5.6	-4.1	
32.	STEEL	35.1	0.8	-3.3	-4.1	
33.	OIL-INTEGRATED, INTERNATIONAL	-6.3	2.1	-2.1	-4.2	
34.	CONTAINERS-METAL AND GLASS	4.4	4.4	0.2	-4.2	
35.	SMALL LOANS	-17.5	0.6	-3.8	-4.4	
36.	PUBLISHING	8.8	6.7	2.3	-4.4	
37.	CONGLOMERATES	6.1	4.8	0.3	-4.5	
38.	OIL-INTEGRATED, DOMESTIC	-8.0	2.8	-1.8	-4.6	
39.	RADIO-TV BROADCASTING	-1.8	5.4	0.8	-4.6	
40.	DIVERSIFIED MACHINERY	9.3	5.0	0.3	-4.7	. . .
41.	RETAIL STORES-MAIL ORDER & GENERAL CHAINS	7.8	6.9	2.2	-4.7	Group 2: (cont'd.)
42.	RETAIL STORES-FOOD CHAINS	3.5	1.6	-3.1	-4.7	
43.	PHOTOGRAPHY	8.3	5.3	0.4	-4.9	
44.	CONTAINERS-PAPER	0.4	4.0	-1.0	-5.0	
45.	OFFICE & BUSINESS EQUIPMENT	0.7	4.3	-0.9	-5.2	
46.	BUILDING MATERIALS - ROOFING & WALLBOARD	-30.2	-5.2	-10.4	-5.2	
47.	BUILDING MATERIALS, HEATING, AC & PLUMBING	-6.9	-0.6	-5.8	-5.2	
48.	COMPUTERS	3.3	4.6	-0.6	-5.2	
49.	ELECTRONIC LABORATORY EQUIPMENT	8.2	7.3	1.8	-5.5	
50.	TRUCK LINES	-2.0	0.6	-4.9	-5.5	
51.	CONSTRUCTION & MATERIAL HANDLING MACHINERY	-6.2	3.4	-2.2	-5.6	
52.	CHEMICALS	-2.4	3.1	-2.5	-5.6	
53.	MEDICAL SUPPLIES & EQUIPMENT	8.8	9.1	3.4	-5.7	
54.	STEAM GENERATING MACHINERY	4.4	1.0	-4.8	-5.8	
55.	PAPER	-6.5	1.3	-4.6	-5.9	
56.	ELECT CONTROLS, SWITCHING & CONNECTOR EQUIP	6.0	5.7	-0.3	-6.0	
57.	RETAIL STORES-VARIETY	-3.9	10.9	4.9	-6.0	
58.	TIRE AND RUBBER	73.7	6.3	0.1	-6.2	
59.	RAILROAD EQUIPMENT	-9.1	0.5	-5.9	-6.4	
60.	RADIO - TV MANUFACTURERS	-10.1	1.0	-5.5	-6.5	
61.	INDUSTRIAL MACHINERY	3.8	3.3	-2.7	-6.0	
62.	ELECTRONIC/ELECTRICAL COMPONENTS & EQUIPMENT	3.5	4.0	-2.9	-6.9	
63.	ELECTRONIC MAJOR COMPANIES	3.4	1.4	-5.6	-7.0	
64.	MACHINE TOOLS	-8.1	4.2	-2.8	-7.0	
65.	FABRICATED METALS	-1.6	-0.5	-7.8	-7.3	Group 3: Recession Susceptible Industries
66.	MISCELLANEOUS METALS & MINING	-34.2	2.5	-5.6	-8.1	
67.	ELECTRIC HOUSEHOLD APPLIANCES	-13.9	-0.9	-9.2	-8.3	
68.	SEMICONDUCTOR MANUFACTURERS	-25.0	7.5	-1.6	-9.1	
69.	BANKS	3.3	10.8	1.5	-9.3	
70.	AEROSPACE	7.4	6.6	-2.8	-9.4	
71.	COPPER	-84.1	-0.9	-11.7	-10.8	
72.	FOREST PRODUCTS	-21.9	-5.2	-16.3	-11.1	
73.	HOME FURNISHINGS	-12.8	3.8	-7.7	-11.5	
74.	ALUMINUM	-25.3	5.0	-7.1	-12.1	
75.	LEAD AND ZINC	-30.6	-10.3	-25.8	-15.5	
76.	COAL-BITUMINOUS	-43.0	25.7	8.5	-17.2	
77.	AUTO ACCESSORIES	-1.3	8.3	-10.5	-18.8	
78.	AIR TRANSPORT	NM	94.4	47.4	-47.0	
79.	AUTOMOBILES	87.5	NM	NM	NM	
80.	AGRICULTURAL MACHINERY	NM	100.4	NM	NM	
81.	SAVINGS & LOAN	NM	NM	NM	NM	

The recovery is expected to begin this spring, the result of a moderate upturn in housing sector activity, a greater pace of auto sales, increased military spending, and an end to the decumulation of inventories that probably began last November. However, not until the second stage of the personal income tax cuts takes effect in July 1982 does the economy really begin to pick up steam again. Led by a rapid pace of consumer spending, real economic growth is forecast to range between 4% and 6% during the second half of this year. Monetary growth accelerates, bringing higher short- and long-term interest rates, but the lower plateau for inflation that is projected prevents interest rates from surging to new peaks. Nevertheless, the renewed upturn of nominal and real interest rates limits the expansion compared with other episodes. Real economic growth of 4.1% in 1983 and 3.5% for 1982 is 1 to 1½ percentage points lower than previous initial years of economic recovery.

One casualty of the high interest rates and slack economic environment is business capital formation. Despite the stimulus from the Accelerated Cost Recovery System (ACRS), business spending on plant and equipment, adjusted for inflation, does not strengthen until 1983 and 1984. The 5.1% and 6.5% rises predicted for those years represent a solid expansion, but considerably less than in most business recoveries. High interest rates, especially long-term, restrain business capital formation to a significant extent by raising the required rate of return on investment and preventing the restructuring of balance sheets toward longer debt maturities that has always been necessary before a capital spending boom.

Inflation rates are forecast to be permanently in single digits throughout the next few years. With so much slack in labor markets and low operating rates, no significant reacceleration of inflation should be expected in the absence of external supply-side shocks. Thus, the lower inflation rates achieved in 1981 are permanent, brought about by a sustained tight monetary policy and its impacts on basic commodity prices, housing prices, precious metals prices, the prices for items affected by high carrying costs of inventories, oil and energy prices, food and raw materials prices. The implicit GNP deflator is forecast to rise 7.5% this year, 7.7% in 1983, and 7.2% during 1984. An even greater improvement for inflation cannot occur, however, given unit labor cost increases still in the 6% to 7% range. Still low productivity growth and rises in wage compensation from 7% to 8% prop the inflation of prices. Energy prices are forecast to remain stable over the next year before rising later in 1983 and 1984. OPEC crude oil prices should drop in real terms in 1982, be essentially unchanged in 1983, then rise slightly during 1984.

For a better performance on inflation to occur, there must be a major breakthrough toward substantially lower wage settlements. With the demand-side elements of inflation mostly eliminated now because of the cyclical downturn in the economy, only the cost-push component of inflation remains. Its largest component by far is wage increases in excess of productivity growth. Since there is little hope for a major upturn in the growth of productivity under the current easy fiscal-tight money twist of policy, the only way to achieve greater gains on inflation is through much lower rises in wages.

Thus, the outcome of the wage negotiations in process now between major unions and key industries in the United States is the key to further progress against inflation during 1982 and beyond. So far, the results of these negotiations are quite promising, with settlements of 9% then 7% wage increases reached with the Oil, Chemical, and Atomic International Workers Union for the next two years and a first year wage freeze reported as the result of negotiations between the Teamsters Union and trucking industry. Negotiations between the auto workers, GM, and Ford also are indicating that a new pattern of wage settlements may be emerging. DRI has not assumed that an unprecedented breakthrough occurs in wages this year. Instead, a significant deceleration of wage inflation is forecast that is consistent with previous cyclical downturns. Compensation per hour, adjusted for overtime and mix, is forecast to rise at 8 to 8½% rates over the next three years.

Should wage negotiations continue to show favorable settlements, inflation and the economy would improve considerably. A paradox is that the better the performance on inflation the greater the federal budget deficit. Under the New Fed Policy, this means potentially higher interest rates. The other side of the coin, however, is that lower inflation rates ease the nominal demands for credit, increase the real returns to saving, raise profit margins for business firms hence cash flow, and may well provide the increased demands for Treasury issues that correspond to the heavier financing associated with a greater deficit.

Interest rate volatility continues to be a prominent feature of the U.S. financial markets. Between October 5, 1979 and March 17, 1980, short-term interest rates rose from 2 to 8 percentage points and bond yields were 275 to 480 basis points higher. The deep slide in the economy during the second quarter of 1980 and easing of Fed policy reduced interest rates by 2 to 13 percentage points. Then, a strong expansion of the economy and a series of restrictive moves by the Federal Reserve brought virtually a complete retracement of the downturns, with interest rates rising from 2 to 12½ percentage points. The next round of declines in money market rates was about the same magnitude as previous changes, but occurred over a much longer period. Since December 1980, the Federal funds rate has dropped over 10 percentage points, with other short-term interest rates down from 450 to 620 basis points. Bond yields, on the other hand, have risen since last year, up from 85 to 245 basis points. This increase is somewhat puzzling, given the much lower inflation rates of 1981 and so weak an economy. Actual and prospective impacts from large federal budget deficits and the necessity of increased returns given the higher risks of capital losses to holders of bonds probably have been responsible for the continuing rises in bond yields. Most recently, interest rates have again reversed direction, backing up higher over the past month with a reacceleration of monetary growth and the prospects of huge federal budget deficits in 1983 and 1984. Thus, the volatility of interest rates since the New Fed Policy shows no sign of abating.

Indeed, to a degree, the current DRI projections for interest rates incorporate a pattern of continuing ups and downs, although not to the extent of past years. The current projections reflect a pause for interest rates at near present levels before a resumption of declines later this quarter. Over the near term, short-term interest rates should fluctuate near current levels. A 12% to 13% trading range for the Federal funds rate seems to have settled in, which with the 12% discount rate has caused other money market rates to align themselves to these levels. Subsequently, another 100 to 300 basis points of declines should occur as business credit demands weaken, Fed policy eases slightly once more, and inflation rates drop lower. The prime rate could rise to over 16% again, but then should drop to 15% in February. Some time during the second quarter, the prime rate should fall to a range to 14%.

The bond market likely will rally late in January on more evidence of a deeper recession, continuing good news on inflation and budget restraint announcements. Inflation rates in the 4% to 6% range, at annual rates, should bring lower bond yields in the months ahead. The bond markets have not yet really begun to discount inflation rates of less than 8% or 9%. Real interest rates will continue to remain at unprecedented high levels, however, given the volatility of the bond market and the huge volume of corporate and U.S. Government debt likely to be issued.

The next "up" for money market rates is forecast to occur during the summer, with a sharp upswing of the economy and money growth above targets. Heavy demands on the financial markets from Treasury financing also will push interest rates higher. Treasury issues are estimated at a $150.5 billion annual rate in the second half, a new record. By year-end, short-term interest rates are about 300 basis points higher and bond yields are up 100 to 200 basis points.

Subsequently, another cycle occurs for interest rates, with declines over 1983:1 to 1983:4, rises into early 1984, then further reductions. The wavelike pattern is milder than the violent fluctuations of the past two years as the economy settles down to a more stable pattern of behavior.

On average, both short- and longer-term interest rates generally decline over the forecast horizon, reflecting adjustments to lower inflation rates. In both nominal and real terms, interest rates remain quite high relative to history, the result of the increased volatility of financial markets, deregulation, and the restraint on monetary growth pursued by the central bank.

Table 11
History and Forecast of Key Interest Rates: 1981:3 to 1984

	1981		1982				1983		Years				
	III	IV	I	II	III	IV	I	II	1980	1981	1982	1983	1984
Short-Term:													
Federal Funds...........	17.58	13.57	12.38	11.01	13.39	14.62	13.85	12.71	13.36	16.37	12.85	13.00	11.44
3-Month Treasury Bills..	15.05	11.74	11.35	10.73	11.87	12.71	12.28	11.48	11.43	14.02	11.66	11.63	10.88
3 Month Commercial Paper	16.77	13.02	11.43	10.91	12.00	13.01	13.58	12.57	12.66	15.32	11.84	12.74	11.71
3-Month CD's............	17.52	13.43	12.59	11.63	12.31	13.37	14.17	13.15	13.05	15.90	12.48	13.33	12.11
Prime Bank Loans........	20.32	16.99	15.32	13.81	14.92	15.46	15.35	15.24	15.27	18.86	14.88	15.04	13.59
Intermediate-Term:													
3-5 Year U.S. Government Bonds......	15.61	14.02	13.10	12.27	12.67	13.29	13.18	12.28	11.51	14.32	12.83	12.33	11.55
Long-Term:													
AA-Utility..............	17.03	16.61	15.25	14.51	14.17	15.50	14.84	13.39	13.14	16.21	14.86	13.55	12.38
Bond Buyer Index of 20 Municipal Bonds....	12.11	12.54	11.39	11.72	12.53	12.36	11.01	10.40	8.58	11.33	12.00	10.39	10.07
U.S. Government Bonds (Constant Maturity)													
10-Year.............	14.85	14.17	13.24	12.75	12.98	13.41	13.02	12.28	11.46	13.93	13.09	12.23	11.28
20-Year.............	14.50	14.12	13.20	12.46	13.13	13.56	13.06	12.62	11.39	13.71	13.09	12.50	11.36
Mortgage Commitment Rate Conventional Loans....	17.35	17.76	15.36	15.29	16.03	16.75	15.75	15.08	14.00	16.67	15.86	15.03	14.31

The fundamental factors underlying the determination of interest rates line up as follows:

- The stagnant economy remains a big plus for the financial markets into the second quarter, as real GNP declines and unemployment rises.
- Inflation rates on a new lower plateau sustain lower interest rates until the second half of 1982, and then prevent them from soaring back to previous peaks.

- The slightly easier tack in monetary policy since mid-July is continued, within the basic posture of gradually slower growth in money. The stance of monetary policy is restrained so long as the economy does not fall into a sustained deep recession and until there is a major, permanent decline of inflation.
- Monetary growth remains under control, except for periodic interruptions, but not low enough for long enough to induce a big easing by the central bank.
- A resilient dollar is a positive factor, losing only a modest amount of its gains, thus helping to keep inflation and interest rates lower.
- Private sector credit demands ease with the economy in a full-fledged recession configuration, with no big resurgence until 1983-84.
- Pressure on the banking system is easier for much of 1982, helping to prevent short-term interest rates from rising.
- The federal budget deficit and Treasury financing are at record levels, the biggest negative for the financial markets.

Table 12
Critical Factors in the Interest Rate Forecast

	1981		1982				1983		Years				
	III	IV	I	II	III	IV	I	II	1980	1981	1982	1983	1984
Factor													
Fed Policy													
Free Reserves (Bils. of dollars)	-1.26	-0.43	-0.39	-0.19	-0.50	-0.72	-0.44	-0.42	-1.14	-1.08	-0.45	-0.52	-0.24
Federal Funds Rate (%)	17.58	13.57	12.38	11.01	13.39	14.62	13.85	12.71	13.36	16.37	12.85	13.00	11.44
Nonborrowed Reserves %CH	10.0	-0.1	6.0	6.0	5.0	5.0	5.5	6.0	2.9	-4.9	4.7	5.5	5.3
Inflation - (%CH - Implicit GNP Deflator)	9.9	9.5	6.1	6.5	7.0	8.2	7.9	7.7	9.0	9.2	7.5	7.7	7.2
The Economy													
Real Growth %CH	1.4	-6.4	-2.5	0.6	5.6	4.7	4.1	4.0	-0.2	1.9	-0.7	4.1	3.5
Unemployment Rate (%)	7.2	8.4	9.1	9.4	9.2	9.0	8.7	8.4	7.1	7.6	9.2	8.3	7.6
The Dollar													
Morgan Guaranty Trade Weighted Exchange Rate %CH...........................	19.1	-11.1	-0.6	-1.2	-2.5	-3.4	-4.0	-4.0	-0.1	9.0	0.3	-3.5	-2.8
Credit Demands (*1) %CH	-5.0	-14.6	-17.6	-2.6	46.9	61.8	17.3	-15.6	-10.5	9.4	0.0	24.5	18.0
Monetary Growth													
M1 (%CH, SAAR)	0.4	5.8	6.0	1.3	6.4	3.3	5.1	5.1	7.3	5.0	4.3	5.0	4.5
M2 (%CH, SAAR)	7.4	11.1	9.5	5.7	9.1	9.7	9.3	9.0	9.6	9.5	8.5	9.7	10.4
Banking System													
Liquidity Tension Index (*2)	153.9	90.9	79.0	102.8	90.1	98.2	98.6	101.7	80.0	149.0	92.5	98.0	95.9
Federal Deficit (NIA, Bils. of dollars)	-55.7	-95.2	-103.4	-103.7	-130.9	-124.8	-107.2	-94.1	-61.2	-61.2	-115.7	-110.1	-103.3

(*1) Credit Demands are defined as the domestic credit demands of the household, nonfinancial corporate, and Federal and State and local government sectors.

(*2) The Liquidity Tension Index is based on the changes in bank loans, including C&I loans, plus real estate and individual loans and the flow of total reserves less changes in demand and savings and small-denomination time deposits - index number, 1977:2 = 100.

The impact of the deficit should not occur until later in 1982, when a sharp recovery of the economy and attempts to restructure corporate debt conflict with the huge volume of Treasury financing that is currently projected. *In the New Fed Policy* environment, impacts of federal government demands for funds are greater than in previous years when the central bank accommodated fiscal stimulus. Both short- and long-term interest rates show increases of 250 to 400 basis points during this period. The still large deficits projected for fiscal years 1983 and 1984 keep upward pressure on interest rates through these years as well. However, the lower inflation rates permit the modest declines of interest rates that are projected, more than offsetting the effects of the deficit. Lower inflation also limits the rise in nominal demands for funds in the recovery, easing pressure on financial markets.

In the DRI forecast, the Federal Reserve is assumed to sustain a policy of gradual reductions in the growth targets for M1 over the next few years. The assumed target ranges are 2½% to 5½% for 1982, 2% to 5% for 1983, and 1½% to 4½% in 1984. These lower growth goals budget the growth in nominal GNP to be in single digits. Given the success so far on inflation from the tough approach by the Federal Reserve and support by the Administration for the basic thrust of monetary policy, it would be imprudent to assume that the Federal Reserve will relent on the monetary growth targets.

More likely is a greater tolerance of money growth near the upper target limits than in 1980 and 1981, when back-to-back recessions occurred. The record level of joblessness, restrained expansion of the economy, and strain on corporations and financial institutions will temper any attempts by the central bank to push money growth too low.

The arithmetic for the forecast of monetary growth, velocity, and nominal GNP is shown in Table 13. The velocity of M1 is far above historical averages, but this is a result of a changing composition of transactions money. M1 contains NOW accounts which more-and-more will be switched to higher interest yielding transactions media which do not appear in M1. A better measure is M2, which includes the money market mutual funds and repurchase agreements that have become so popular with households and corporations. The M2 velocity growth is quite typical with above average growth in 1983, an expansion year, and much lower growth during 1984.

Table 13
The Arithmetic of Velocity
(Percent change, 4th Qtr. to 4th Qtr., unless otherwise specified)

	1980	1981	1982	1983	1984	Average Growth 1959:1 to 1980:4
GNP	9.4	9.2	9.5	11.9	10.7	8.4
Implicit GNP Deflator	9.8	8.9	6.9	7.8	6.9	4.8
M1	7.3	5.0	4.3	5.0	4.5	5.1
M2	9.6	9.5	8.5	9.7	10.4	8.4
M1 Velocity	2.0	4.2	4.9	6.6	5.9	3.1
M2 Velocity	-0.2	-0.3	1.0	2.0	0.2	-0.1
90-day Treasury Bills (Percent)	13.6	11.7	12.7	11.8	9.4	
20-Year U.S. Government Bond (Percent)	12.2	14.1	13.6	12.2	10.6	

The DRI forecast of Federal Reserve policy also is contingent upon a tightening of the budget by the Reagan Administration for FY83 and FY84, through the reductions in spending and increases of taxes described in Section V below. The central bank will be quite prepared to ease up on monetary policy in return for a restriction of the budget, so long as growth in the economy and inflation keep M1 and M2 growth within target ranges.

IV. Reaganomics - Success or Failure?

Will Reaganomics be a success or a failure? The DRI forecast provides a distinctly negative answer for the near-term but is optimistic for the longer-run. By 1983 and 1984, the major parameters of the economy are all moving in the direction of the administration goals, although not reaching them (Table 5). Real economic growth is less than originally sought by the administration; inflation rates are higher, although diminishing; the unemployment rate is higher, although falling; and interest rates are lower than currently, although higher than the original administration projections. The deep recession and stagnant economy of 1980-82, lower inflation rates, lower interest rates later and fiscal stimulus of 1983 and 1984 produce the forecasted patterns.

However, these results are contingent on a serious attempt by the Reagan Administration and Congress to reduce the deficits that would occur under the current services budget that is consistent with the 1981 Reconciliation Act and Economic Recovery Tax Act. On an NIA basis, the deficits are $108.3 billion in FY82, $111.9 billion in FY83, and $110.0 billion in FY84. These figures are based on the projections for real economic growth, unemployment, inflation, and interest rates shown in Table 5. Without assumptions in the forecast of further reductions in nondefense spending, military outlays, and grants-in-aid to state and local governments totalling $76.9 billion by 1984 and increases for excise, gasoline, and windfall profits taxes reaching $20.5 billion, the deficits would be a much larger $125.3 billion, $152.0 billion and $188.9 billion during the next three fiscal years. This would bring higher interest rates and a worse performance for the economy.

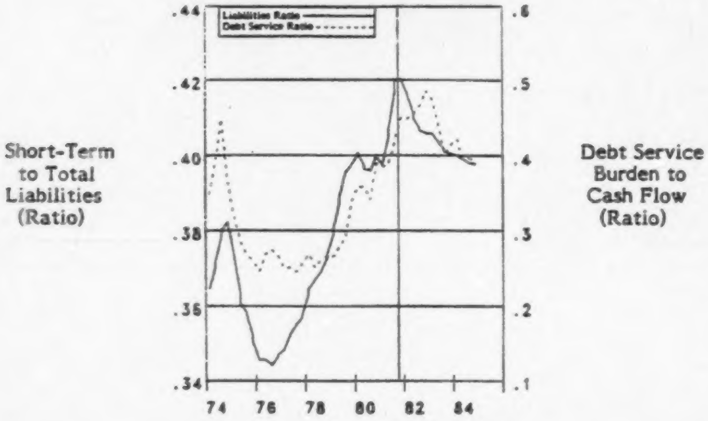
Reaganomics does not provide much stimulus for the economy until the second half of 1982. Most of the fiscal stimulus is programmed for 1983-84. By then, the cumulative effects of the personal tax reductions will be very large; business tax incentives will be effective; and military spending will be impacting. In the short-run, the past two-and-a-half years of tight money and so little fiscal stimulus have been a cause of recession. However, this may well benefit the economy in the later years of the Reagan Administration, since the lower inflation and lower interest rates that should result from the recession and slack in the economy will provide considerable room for growth.

Success on inflation is for sure. The role of the federal government will be whittled down. A surge in capital spending is likely for the mid-80s. Once there is less slack in the economy, the big new savings and investment incentives should have a large impact. But the costs, including jobs, the potential for high interest rates because of large deficits, and chronic weakness in certain areas and sectors, will be sizeable. The "wild card" is the fallout on wages, inflation, saving, and productivity growth of the recession. If all breaks right, there will be success for the major parameters in the longer run, despite the shaky start.

The greatest risk to the current economic policies is the possibility of a major collapse from the cumulative effects of tight money and stagnation. The fragile U.S. economy can not tolerate much more restriction without risking the debt-deflation possibility of the 1930s. Already, the unemployment rate is near the postwar peak and concern over jobs is fast replacing inflation in the minds of the public.

A second risk is the survival of many corporations and financial institutions. The growing list of firms and depository institutions that are in danger of failure from having to curtail their activities sharply because of the recession and financial squeeze is probably longer than at any time during the postwar period. For corporations, the negative impact on profits from the long period of stagnation and current recession is squeezing cash flow. Debt burdens and debt ratios of short- to long-term liabilities are at record levels for the postwar period. Cost structures also are squeezing profit margins. It may be that a fundamental reshaping will be necessary in the corporate sector to restructure businesses for future survival in a new volatile environment that is becoming increasingly deregulated.

Chart 3
Ratio of Nonfinancial Corporate Short Term Liabilities to Total Liabilities and Ratio of Nonfinancial Corporate Debt Service Burden to Cash Flow



A third risk is that the New Fed Policy may require repeated rises of interest rates before the economy has recovered. Already in 1982, M1 is considerably above the targets set for this year by the central bank. Interest rates have risen in response, principally from market reactions but also due to a slight restriction in bank reserves by the Federal Reserve. Should monetary growth reaccelerate to above stated target limits, a possibility even in an economy that is chronically recessed, the automatic working of the New Fed Policy may well bring substantial rises of interest rates that will strangle the economy even before it can recover again. The rises of interest rates in December and early January during a full-fledged recession is a sobering reminder of the New Fed Policy experiment, which could subject the economy to perverse effects so long as the New Fed Policy is in place.

V. The Deficit - Problems and Perspectives

The recession, declining rates of inflation, the Economic Recovery Tax Act of 1981, prospects of large increases in military spending, and high nominal interest rates suggest substantial federal budget deficits in the next few years. Table 14 shows the current DRI projections for the federal budget deficit, both on the NIA and unified bases for FY82, FY83 and FY84. The key parameters that underlie the forecasted deficits also appear. The assumptions on the Reagan Administration initiatives to reduce the deficit are indicated in Table 15.

Table 14
Federal Budget Deficit Outlook

	Fiscal Years				
	1980	1981	1982	1983	1984
Unified Budget Basis					
Receipts	520.1	602.6	620.4	685.3	750.0
Outlays	579.6	660.5	728.5	786.0	839.8
Surplus or Deficit (-)	-59.5	-57.9	-108.1	-100.7	-89.8
National Income Account Basis					
Receipts	526.0	612.5	628.1	687.1	747.7
Expenditures	576.4	666.8	736.4	799.0	857.7
Surplus or Deficit (-)	-50.4	-54.4	-108.3	-111.9	-110.0
GNP (1972 $'s, % chg.)	0.3	1.7	-1.1	3.7	3.7
Implicit GNP Deflator (% chg.)	8.6	9.4	8.0	7.5	7.4
Unemployment Rate (%)	6.8	7.4	9.0	8.5	7.7
90-Day Treas. Bill Rate (%)	11.0	14.5	11.4	11.9	11.5

The NIA deficits are $108.3 billion, $111.9 billion and $110.0 billion for the three fiscal years. The unified budget deficits are $108.1 billion, $100.7 billion, and $89.8 billion, lower in the later years as the federal government turns to new cash management techniques and sales of off-shore leases. Without the DRI assumptions of ex-ante increases for the tax on gasoline, new excise taxes on liquor and tobacco, a 50% "windfall profits" tax on natural gas as a result of accelerated decontrol of "old interstate" gas, some modest reductions of military spending, sizeable reductions in nonmilitary spending, and sharp cutbacks in grants-in-aid to states and localities, the NIA deficits for FY82, FY83 and FY84 would be $125.3 billion, $164.8 billion and $207.4 billion.[2]

---

[2] Of course, the more stimulative budget from the ex-ante deficits of $125.3, $164.8 and $207.4 billion would raise economic growth and inflation, lower unemployment, and reduce the deficit ex-post. Simulation of the DRI model produced ex-post NIA deficits for FY82, FY83 and FY84 of $120.3, $152.0, and $188.9 billion.

Table 15
Reagan Administration Initiatives to Reduce the Deficit
DRI Forecast 1/15/82*
(Billions of Dollars)

	FY82	FY83	FY84
Outlays			
Military Spending	---	-5.0	-10.0
Nonmilitary Spending	-3.0	-11.4	-23.5
Grants-in-aid to States & Localities	-14.0	-27.3	-39.9
Other[1]	2.8	5.3	-2.1
Subtotal	-14.2	-38.4	-76.9
Revenues			
Natural Gas Decontrol Windfall Profits Tax	---	3.0	6.0
Excise Taxes - Liquor, Tabacco	---	7.5	10.5
Gasoline Tax	---	4.0	4.0
Subtotal	---	14.5	20.5
Total (Gain in Revenues less Reduction in Outlays)	14.2	52.9	96.0

*Changes relative to current services federal budget consistent with the 1981 Reconciliation Act, proposed 7% per annum real increases in military spending, and the provisions of the Economic Recovery Tax Act of 1981.

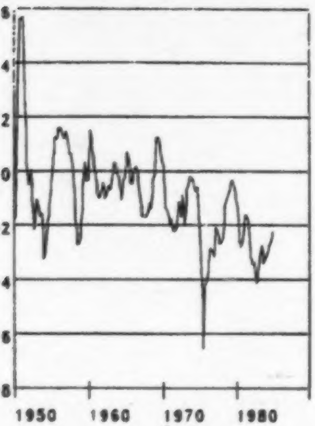
[1] Transfers to Persons, Federal Government Pay Increases, Subsidies less Current Surplus of Government Enterprises

These deficits are at record levels, although not so as a percent of nominal GNP. For FY82, the deficit is mostly "passive," i.e., the result of a weak economy, lower inflation rates, still high interest rates, and only a small amount of fiscal stimulus. But in FY83 and FY84 the deficits are "active," occurring in an economy that is growing above potential, with inflation rates that are rising or stable, and from a large injection of fiscal stimulus. The "active" nature of the triple-digit deficits are defined by the strength of the economy and fiscal stimulus, in this case mostly tax reductions. Under the New Fed Policy, the accompanying financing by the U.S. Treasury will not be accommodated unless monetary growth is within or below Federal Reserve targets. Thus, the impacts of a given deficit in the new structure can be expected to be higher interest rates and less expansion by interest rate sensitive sectors of the economy than before the New Fed Policy.[3] The paradox is that a rising deficit itself can bring about an even worse deficit through raising interest rates, slowing real growth, increasing unemployment, and restraining inflation. Measures to reduce the deficit, such as raising taxes or lowering spending, could reverse this set of results.

---

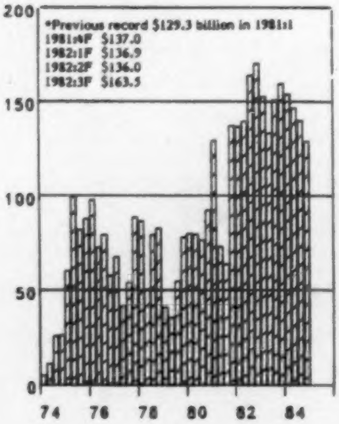
[3] See A. Sinai, "New Approaches to Stabilization Policy and the Effects on U.S. Financial Markets," National Tax Journal, September 1981, pp. 341-372.

Chart 4
NIA Deficit Relative to GNP:
History and Forecast
(Percent)



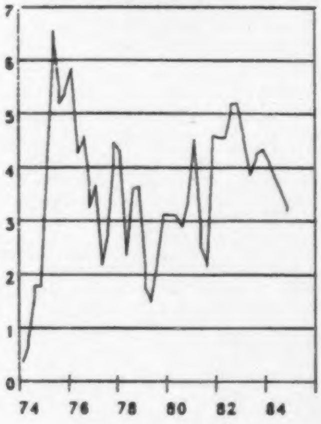
Are the projected deficits large? In absolute terms, the projected deficits far exceed the previous records of $69.3 billion in 1975 and $53.1 billion in 1976. But, relative to nominal GNP, the NIA deficits and associated Treasury financing are not anywhere near record proportions, given the assumed package of tax hikes and spending cuts in the DRI Control projections.

Chart 5
New Issues of Treasury Debt*
History and Forecast
(Bils. $'s, SAAR)



*Previous record $129.3 billion in 1981:1
1981:4F $137.0
1982:1F $136.9
1982:2F $136.0
1982:3F $163.5

Chart 6
New Issues of Treasury Debt
Relative to GNP:
History and Forecast
(Percent)



What are the impacts of such large deficits? Historically, the periods of largest deficits have been associated with interest rates that were declining or at troughs. This was the case in 1958, 1967, 1970-71 and 1975-76, where record deficits in absolute and relative terms were associated with declining short- and long-term interest rates.

The explanation for this phenomenon is straightforward. Most previous record deficits have been "passive," the result of lessened tax receipts from a weak economy, declining rates of inflation, and higher transfers for the unemployed and welfare support. At the same time, the slack in the economy has been substantial with high unemployment rates, low capacity utilization rates, and large gaps between potential and real GNP. A reacceleration of inflation has been slow to occur in these circumstances.

In this situation, the private sector generally is spending less, borrowing less, and rebuilding the financial side of the balance sheet--the process of reliquefication. The lessened credit demands of the private sector and greater demands for financial assets have proved complementary to the heavy financing needs of the U.S. Treasury, with demands for high-quality U.S. Treasury securities outweighing the supplies and causing declines for interest rates. At the same time, other purchasers of the debt, such as the rest-of-the-world and the Federal Reserve have helped to depress interest rates.

Table 16
Deficit Financing and Interest Rates: History and Forecast

	($ Bils.) NIA Deficit	(%) Deficit Relative to GNP	(%) Treasury Bill Rate	New Issue Corporate Bond Rate (%)	U.S. Govt. Bond (%) 20 Year Constant Maturity
1950	9.250	3.2	1.20	NA	NA
1951	6.500	2.0	1.52	3.04	NA
1952	-3.675	-1.1	1.72	3.10	NA
1953	-7.075	-1.9	1.89	3.42	NA
1954	-6.075	-1.7	0.94	2.90	2.64
1955	4.500	1.1	1.73	3.17	2.90
1956	5.975	1.4	2.63	3.68	3.14
1957	2.225	0.5	3.22	4.45	3.54
1958	-10.375	-2.3	1.77	4.02	3.48
1959	-1.125	-0.2	3.39	4.77	4.13
1960	3.025	0.6	2.88	4.68	4.06
1961	-3.875	-0.7	2.35	4.42	3.92
1962	-4.225	-0.7	2.77	4.23	3.99
1963	0.250	0.0	3.16	4.25	4.05
1964	-3.275	-0.5	3.55	4.40	4.19
1965	0.525	0.1	3.95	4.54	4.27
1966	-1.800	-0.2	4.85	5.44	4.77
1967	-13.175	-1.6	4.30	5.77	5.01
1968	-6.075	-0.7	5.33	6.48	5.45
1969	8.425	0.9	6.66	7.68	6.33
1970	-12.425	-1.3	6.39	8.50	6.86
1971	-22.025	-2.0	4.33	7.36	6.12
1972	-16.800	-1.4	4.07	7.16	6.01
1973	-5.575	-0.4	7.03	7.65	7.12
1974	-11.525	-0.8	7.83	8.96	8.05
1975	-69.300	-4.5	5.77	9.01	8.19
1976	-53.100	-3.1	4.97	8.33	7.86
1977	-46.375	-2.4	5.27	8.06	7.67
1978	-29.225	-1.4	7.19	8.88	8.48
1979	-14.825	-0.6	10.07	9.86	9.33
1980	-61.225	-2.3	11.43	12.47	11.39
1981	-61.175	-2.1	14.02	15.01	13.71
1982	-115.684	-3.7	11.66	14.22	13.09
1983	-110.055	-3.1	11.63	12.95	12.50
1984	-103.323	-2.7	10.88	11.83	11.36
1985	-61.036	-1.4	9.88	10.99	10.31

For the future, however, the impacts could be different. In 1980 and 1981, rising deficits were associated with rising interest rates. This occurred despite a double-dip recession. In part, rising or still high inflation rates helped to prop the interest rates. But, perhaps most importantly, the Federal Reserve was not a major buyer of new Treasury debt issues. The portion of U.S. Treasury debt picked up by the Federal Reserve since the New Fed Policy has been considerably less than in previous years (Table 17). In 1980 the central bank absorbed only $4.4 billion or 3.6%, of the issues. The estimates for 1981 so far are $2.1 billion and 1.6%. In other years of high deficits and declining interest rates, the central bank purchased from 9% to 28% of the total that was issued. Finally, private sector spending has not been weak for long enough to generate the sustained reliquefication necessary to more fully absorb U.S. Government debt issues. Thus, the higher pattern of interest rates and higher deficits are a warning for the future, although ultimately the impact of the deficit on rates must still depend greatly on the cause of the deficit and initial conditions in the economy.

Table 17
Federal Deficit Financing and the Holders: Who Buys The New Treasury Debt?
(Bils. of $'s, SAAR, except as otherwise indicated)

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
NIA Deficit Relative to GNP (%)	1.1	1.4	0.5	-2.3	-0.2	0.6	-0.7	-0.7	0.0	-0.6	0.1	-0.2	-1.6	-0.7	0.9	-1.3
Total Issues: On and Off Budget; also Sponsored Agencies	0.2	-5.3	-0.9	9.0	9.0	-1.7	7.7	8.4	5.6	6.7	3.9	9.2	13.2	17.4	6.2	21.7
Purchased by:																
Federal Reserve	-0.1	0.1	-0.7	2.1	0.3	0.7	1.5	1.9	2.8	3.5	3.7	3.5	4.8	3.8	4.2	5.0
(Percent of Total)	NM	NM	73.1	23.5	3.3	NM	19.5	23.2	49.9	51.4	95.5	38.6	36.7	21.7	68.5	23.0
Private Domestic	-0.8	-6.6	-0.3	6.7	5.5	-3.2	5.8	4.8	1.8	3.2	0.1	5.8	6.3	14.1	5.8	6.4
Nonfinancial	7.4	-2.0	0.2	-2.8	13.3	-5.9	-1.0	1.4	4.8	1.0	3.3	7.7	-1.1	8.6	17.7	-7.3
Households	2.4	1.8	0.6	-3.3	5.9	-0.5	0.2	1.8	0.1	2.1	1.9	7.2	1.1	5.7	16.6	-4.6
Corporations	4.1	-4.5	-0.7	0.3	6.1	-6.0	-1.5	-1.8	3.2	-1.3	-1.7	-1.7	-2.5	0.8	-3.1	0.2
States & Localities	1.0	0.7	0.3	0.2	1.3	0.7	0.3	1.4	1.5	0.2	3.1	2.1	0.2	2.2	4.2	-2.9
Financial	-8.2	-4.7	-0.5	9.5	-7.8	2.6	6.9	3.4	-3.0	2.2	-3.2	-1.8	7.4	5.5	-11.8	13.8
Banking	-8.1	-3.5	-0.3	8.8	-8.8	2.5	6.3	1.3	-2.9	0.3	-2.8	-3.1	9.5	3.4	-10.0	10.8
Nonbank Financial	-0.1	-1.2	-0.2	0.7	1.0	0.1	0.6	2.1	-0.1	1.9	-0.4	1.3	-2.1	2.1	1.8	3.0
Rest-of-World	1.1	0.8	0.2	0.1	3.0	0.5	0.5	1.3	0.6	0.4	-0.1	-2.5	2.1	-0.5	-2.0	9.3
Sponsored Credit Agencies	0.1	0.3	-0.1	0.1	0.1	0.1	-0.1	0.4	0.4	-0.4	0.1	0.9	0.0	-0.1	-0.6	1.1

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981F	1982F	1983F	1984F
NIA Deficit Relative to GNP (%)	-2.0	-1.4	-0.4	-0.8	-4.5	-3.1	-2.4	-1.4	-0.6	-2.3	-2.1	-3.7	-3.1	-2.7
Total Issues: On and Off Budget; also Sponsored Agencies	30.9	23.6	28.3	31.9	94.9	84.6	79.8	90.5	85.7	122.3	135.6	164.0	160.8	147.7
Purchased By:														
Federal Reserve	8.7	0.4	9.3	5.2	8.4	10.0	7.2	7.3	7.6	4.4	2.1*			
(Percent of Total)	28.1	1.8	32.8	16.4	8.9	11.8	9.0	8.1	8.8	3.6	1.6			
Private Domestic	-3.5	16.0	18.8	22.5	76.9	61.5	45.1	54.3	91.9	106.7	121.4*			
Nonfinancial	-10.9	4.2	18.8	19.1	25.4	-16.4	24.1	35.6	62.7	32.6	59.0			
Households	-12.3	0.4	18.5	19.8	18.7	10.3	16.9	30.7	51.8	20.5	40.0			
Corporations	2.5	-2.1	-3.4	2.3	8.7	2.1	-4.1	-3.7	-0.4	-2.1	8.3			
States & Localities	-1.0	5.9	3.7	-2.9	-2.1	4.1	11.3	8.6	11.3	14.2	10.7			
Financial	7.3	11.8	0.0	3.4	51.6	45.2	21.0	18.7	29.1	74.1	62.4			
Banking	7.1	6.5	-1.3	0.7	30.0	20.2	-1.1	0.5	7.9	25.6	12.3			
Nonbank Finance	0.2	5.3	1.3	2.7	21.6	25.0	22.1	18.2	21.2	48.5	50.1			
Rest-of-World	26.3	8.4	0.2	3.7	8.1	11.6	31.5	28.2	-14.0	10.5	5.2*			
Sponsored Credit Agencies	-0.5	-1.2	0.0	0.4	1.5	1.5	-3.8	0.6	0.2	0.7	0.6*			

* Average through 1981:3

The major determinants of the Federal budget deficit include the rate of inflation, real economic growth, the unemployment rate, and interest rates. Each factor has a particular impact on the deficit, in some cases both receipts and outlays, and others, only receipts or outlays. Lower inflation reduces receipts and outlays, but the decline in receipts is greater thus increasing the deficit. Reduced real economic growth tends to reduce receipts and raise outlays, increasing the deficit. A higher unemployment rate reduces receipts through its effects on economic growth and requires increased outlays, thus raising the deficit. Higher interest rates principally impact on outlays, through the net interest on the outstanding new issues of Treasury debt.

Table 18
Effect of Economic Assumptions on Budget Estimates (Billions, fiscal years)

	1982	1983	1984	1985	1986
Inflation: Effect of a One Percentage Point Increase in the Annual Rate Starting Jan. 1982					
Change in Receipts	5	16	30	49	71
Change in Outlays	1	5	11	16	23
Change in Surplus	4	11	19	33	49
Real GNP Growth: Effect of a One Percentage Point Decrease in the Annual Rate Starting Jan. 1982					
Change in Receipts	-5	-12	-21	-31	-44
Change in Outlays	3	5	13	16	22
Change in Surplus	-8	-17	-33	-47	-66
Unemployment Rate: Effect of a One Percentage Point Increase in the Annual Rate Starting Jan. 1982					
Change in Receipts	-12	-17	-18	-20	-21
Change in Outlays	7	11	12	13	14
Change in Surplus	-19	-28	-30	-33	-35
Interest Rates: Effect of a One Percentage Point Increase in the Annual Rate Starting Jan. 1982					
Change in Receipts		1	1	1	1
Change in Outlays	2	5	6	7	8
Change in Surplus	-2	-4	-5	-6	-7

Source: Congressional Budget Office, Baseline Budget Projections: Fiscal Years 1982-1986, July 1981, p. 19; see also Office of Management and Budget, Budget of the United States Government Fiscal Year 1982, January 1981, p. 57-61.

A given deficit can arise from an almost unlimited combination of these factors. If high deficits are "passive" arising from a weak economy, lower inflation, and high unemployment rates, the impacts on interest rates in the economy would be quite different than if the deficit is "active." Active deficits arise from increases in spending, decreases in taxes, i.e., a situation of fiscal stimulus either in an expanding or stable economy. Since the sources of "active" deficits are generally stimulative to the economy, it should be expected that interest rates would rise with high deficits that are active.

The final determinant of the impacts of deficits on the financial markets in the economy is the demands for Treasury issues at the time when the deficits are high. If the deficit is "passive", then it is likely that a weak private sector will also be saving and actively purchasing Treasury debt issues. On the other hand, when the high deficit is "active" the stimulative nature of the cause of the deficit or a strong private sector economy makes less funds available to absorb the greater volume of Treasury debt issues. The role of the Federal Reserve also is critical here, since the central bank is a potential major buyer of the deficit.

As Table 19 shows, the impact on interest rates, both short- and long-term, from a $30 billion ex-ante increase in the deficit caused by higher spending or lower taxes is substantially different from the effects when the deficit arises from lower inflation or a weak economy, or both. In the former case, interest rates move sharply higher along with the deficit. In the instance of lower inflation, interest rates drop even though the deficit rises. For a weak economy, a big enough rise in the deficit can bring somewhat higher short-term rates.

Table 19
Impacts on Short- and Long-Term Interest Rates
From "Passive" and "Active" Federal Budget Deficits
($30 Billion Ex-Ante Increase of NIA Deficit, Created by Different Sources, Changes Relative to Baseline)

	Fiscal Years		
	1982	1983	1984
Source of Higher Deficit:			
Higher Spending			
90-Day Bill Rate	0.7	0.8	0.6
New Corp. Bond Rate	0.4	0.8	0.8
NIA Deficit, Ex-post	-16.5	-13.5	-14.0
Lower Taxes			
90-Day Bill Rate	0.6	0.7	0.5
New Corp. Bond Rate	0.2	0.3	0.3
NIA Deficit, Ex-post	-28.4	-26.2	-26.7
Lower Inflation			
90-Day Bill Rate	-0.5	-1.5	-2.6
New Corp. Bond Rate	-0.1	-0.3	-0.6
NIA Deficit, Ex-post	-6.4	-6.1	-8.7
Weak Economy			
90-Day Bill Rate	-0.5	0.1	0.7
New Corp. Bond Rate	0.0	-0.8	-0.9
NIA Deficit, Ex-post	-25.2	-46.3	-44.5

Since the big deficit for FY82 is essentially "passive," interest rates probably will not move higher as a result, instead be affected more by other factors such as expected inflation, credit demands, Federal Reserve policy, and the volatility of financial markets.

The real problem is in FY83 and FY84 when the deficit will be "active." A large volume of Treasury financing under the fiscal stimulus of Reaganomics could again clash with an expansion of economic activity in the private sector to bring sustained high or rising interest rates. In the extreme, it is even possible that the economic expansion could abort, with no real gain because of the clash between monetary and fiscal policy. Expectations effects on the financial markets from the prospects of the fiscal stimulus to come in FY83 and FY84 and heavy Treasury financing is being reflected in the bond markets already, in a "rational expectations" implication of these policies and in a repudiation of supply-side theory as the correct explanation for the working of the U.S. economy. This result is counterproductive since it limits capital formation and productivity growth, thus interfering with further progress on inflation.

Therefore, it is absolutely necessary for the Administration to make a major move to tighten the budget so as to relieve potential pressure on inflation, to ease congestion in the financial markets, to make it easier for the Federal Reserve to ease monetary policy, and to reduce inflation expectations. A turn toward a tighter fiscal policy would weaken the economy and induce the Federal Reserve to inject bank reserves to sustain the targeted rate of monetary growth in a turn toward easier monetary policy. So long as the central bank did not exceed its targeted money growth rates, the slack built up by the tighter fiscal policy would be offset by lower interest rates. Interest rate sensitive activities in the economy would be stimulated without reigniting inflation.

A critical element in this approach has to do with the impact of inflation expectations. It must be presumed that the current configuration of policy has proved quite damaging for the expected rate of inflation, as manifested in the huge spread between nominal long-term bond yields and current rates of inflation. Real long-term interest rates are at record highs, before and aftertax, indicating that future policies will not contain inflation. To the extent that a turn toward tighter fiscal policy would alleviate this concern on inflation, extra benefits could accrue to the economy. Indeed, it is "rational" to expect a tighter fiscal-easier monetary policy mix to bring a better performance on inflation, hence the financial markets will likely rally as soon as the Reagan Administration indicates its willingness to substantially tighten the budget.

VI. Can We Do Better? Choices and Considerations

In the current environment, it is extremely important for the Reagan Administration to tighten fiscal policy, especially for fiscal years 1983 and 1984. Unless inflation rates drop more sharply than currently is expected, the combination of a recovering economy, tax cut stimulus, and increased military spending will require much higher levels of nominal and real interest rates for the Federal Reserve to achieve its money growth targets. While the DRI forecast is sanguine that a resurgence to new peaks for interest rates and another recession will not occur, the potential damage from another clash between monetary policy restraint and the economy could be more than corporate America can withstand. The risk of a third recession in three years, and perhaps a major collapse, is too great to take a chance.

Using the DRI Quarterly Model of the U.S. Economy, three programs of fiscal restraint were analysed. The first assumed a major turn toward tighter fiscal policy compared with the current situation, announced later in January by President Reagan. Table 20 summarizes this program, characterized as "Stringent Budget Restraint." The fiscal restraint consisted of reductions in spending and increases in taxes across-the-board. Some $11.4 billion of reductions in nondefense spending is assumed to be implemented for FY83 and then $23.5 billion for FY84. Military spending is cut slightly, by $5 and $10 billion over the two years, but still grows at a 6% annual rate, in real terms. Grants-in-aid to states and localities are lowered by $20.5 and $29.9 billion in FY83 and FY84, but the Reagan Administration does earmark $10 billion of new tax revenues for states and localities to help in the provision of services taken over from the federal government. The "5-10-10" personal income tax reductions are halved to "5-5-5," preserving the thrust toward lower marginal tax rates of the original legislation, but raising $33.1 billion of new receipts by FY84. Excise taxes on liquor and tobacco account for new receipts of $4.9 and $11 billion. A "windfall profits" tax on deregulated natural gas raises $3 and $6 billion. Finally, a hike in the gas tax increases receipts $4 billion by FY84. The total saving to the federal budget of this program, ex-ante, is $70.1 billion in FY83 and $119.1 billion in FY84.

Table 20
Stringent Budget Restraint*

	FY82	FY83	FY84
	(Bils. of $'s, SAAR)		
NIA Deficit			
Ex-Ante	-105.2	-92.0	-87.6
Ex-Post	-103.2	-80.0	-64.4
Outlays	-15.5	-39.7	-67.0
Military	0.0	-5.0	-10.0
Nondefense	-3.0	-11.4	-23.5
Federal Pay Increases	0.0	-0.1	-0.1
Subsidies	-2.0	-2.7	-3.5
Grants-in-Aid to State & Local Gov'ts.	-10.5	-20.5	-29.9
Revenues	3.9	30.4	52.1
Personal Tax Receipts ("5-5-5")	3.9	19.5	33.1
Tax on Motor Gasoline	0.0	3.0	4.0
Indirect Business Taxes & Nontax Accruals	0.0	7.9	15.0
TOTAL	19.4	70.1	119.1

*Program of "stringent budget restraint" announced late in January 1982 by the Reagan Administration. Reductions in military and nonmilitary spending, although military spending still rises 6% per year, in real terms. Subsidies and pay increases reduced. Aid to state and local governments cut, but $10 billion of tax increases from "5-5-5" channeled to the state and local government sector. Revenues raised through reducing personal income tax cuts to "5-5-5" from "5-10-10", an increase in the gasoline tax, excise taxes on liquor and tobacco, and "windfall profits" tax on deregulated natural gas.

It is assumed that upon announcement of this program of strict budget restraint, the "rational expectation" of the financial markets and wage-earners is for an even more slack economy and lower inflation. The expected rate of inflation in the model is lowered modestly to reflect this assumption. Indeed, without any intervention by the Federal Reserve, this turn toward restraint certainly would sustain the recession for considerably longer. However, it is also assumed that the Federal Reserve eases in response by moving to a policy of "upper limit" monetarism, i.e., providing sufficient bank reserves to raise monetary growth to the upper limits of the year-over-year growth targets. Those targets are 5.5% in 1982, 5% in 1983 and 4.5% in 1984. Thus, the central bank continues to reduce its monetary growth targets even in the face of the fiscal restraint, but still adds substantial amounts of bank reserves to the banking system given the restrictive effects on the economy from the near $120 billion dose of fiscal restraint. The Reagan Administration budget proposals under this scenario call for deficits of $105.2 billion in FY82, $92 billion for FY83, and $87.6 billion in FY84.

Table 21 shows the ex-post effects on the economy, inflation, financial markets, NIA deficit, and some interest rate sensitive activities from this twist in policy toward a "tighter fiscal-easier money" configuration.

Real GNP is essentially unchanged over the three years, with substantial strength evidenced in housing, business fixed investment, and auto sales from the "tighter fiscal-easier monetary" policy mix. Housing starts are up from 117,000 to 610,000 units for the three years, real business fixed investment rises from $1 to $3.4 billion, and auto sales are up 600,000 units by 1984.

Interest rates are substantially lower, with the 90-day Treasury Bill rate down from 2 to 5 percentage points, the AAA-equivalent yields on top-quality corporate bonds off 1 to 1.6 percentage points, and long-term government bond rates almost 2 percentage points lower in 1984. Mortgage rates also dropped sharply, easing by 60 to 160 basis points between 1982:1 and 1984:4.

The NIA deficit moves sharply lower, as the feedback effects from increased real economic growth and lower interest rates lower the deficit by more than is originally planned. The volume of Treasury issues is over $300 billion lower, at annual rates, during 1984, helping to keep interest rates down. Inflation is only somewhat lower, reflecting the rather modest assumptions about reduced inflation expectations as a result of the new policy twist.

Table 21
"Tighter Fiscal-Easier Monetary" Policy Mix: $119.1 Billion Package of Higher Taxes, Lower Expenditures, and M1 Growth at Upper Targeted Limits as Announced in January 1982 (Changes Relative to Baseline Simulation "High Deficits")*

	Years		
	1982	1983	1984
Real GNP (% chg.)	0.3	-0.1	-0.3
NIA Deficit (Bils. of $'s, SAAR)	34.3	97.5	149.4
Treasury Debt Issues (Bils. of $'s)	-40.0	-156.5	-341.3
Treasury Bill Rate (%)	-2.0	-3.2	-5.0
New Issue Rate on Corp. Bonds (%)	-1.0	-1.3	-1.6
U.S. Govt. Bond Rate (%)	-0.7	-1.3	-1.8
Mortgage Commitment Rate (%)	-0.6	-1.0	-1.6
GNP Price Deflator (%)	-0.2	-0.1	-0.1
Consumer Price Index - All Urban (%)	-0.4	-0.3	-0.4
Unemployment Rate (%)	0.0	-0.1	0.0
Housing Starts (Mils. of Units, SAAR)	0.117	0.407	0.610
Business Fixed Investment (Bils. of 72 $'s, SAAR)	1.0	2.7	3.4
Auto Sales (Mils. of Units, SAAR)	0.4	0.5	0.6
Personal Consumption Expenditures (Bils. of 72 $'s, SAAR)	3.7	-0.8	-7.3

*President Reagan is assumed to announce in January an ex-ante reduction in the federal budget deficit that reaches $119.1 billion by fiscal 1984. Spending reductions of $67.0 billion and rises in taxes of $52.1 billion are recommended and approved. The Federal Reserve provides the reserves necessary to raise M1 to its assumed upper target limits of 5.5%, 5%, and 4.5% for 1982, 1983, and 1984. The tighter fiscal-easier monetary policy mix is assumed to reduce the expected rate of inflation 1.5 percentage points by 1982:4, as the rational expectation to the changes in policy. The comparisons are relative to a baseline simulation (High Deficits) that includes the current services federal budget consistent with the 1981 Reconciliation Act, the proposed 7% per annum real increases in military spending, and the provisions of the Economic Recovery Tax Act of 1981.

The results of the DRI assumptions on the Reagan policy proposals embodied in the baseline forecast are shown in Tables 22 and 23. Here, some $96 billion of planned reductions in the deficit are announced later this month. The planned NIA deficits are $110.4 billion, $112.8 billion, and $110.7 billion for fiscal years 1982, 1983 and 1984. Here, the central bank is not assumed to raise monetary growth to upper targeted limits, just to reduce its growth targets over the next three years. The results show a substantial easing of interest rates and shift in the mix of economic activity to housing, but are not so beneficial as in the more extreme tightening of fiscal policy and easing of monetary policy of the "Stringent Budget Restaint" case. However, depending on the impact to expected inflation and the response of the Federal Reserve, this package of restraint still could be very constructive.

What is most necessary is a surprise to the financial markets in the Reagan budget proposals to obtain the maximum beneficial impact on expected inflation, the financial markets, and the performance of the economy. Thus, the larger the dose of fiscal restraint and turn to an easier monetary policy, the better the results, so long as the monetary growth targets are not violated.

Table 22
Moderate Budget Restraint
(DRI Interim Forecast)

	FY82	FY83	FY84
	(Bils. of $'s, SAAR)		
NIA Deficit			
Ex-Ante	-110.4	-112.8	-110.7
Ex-Post	-112.7	-121.5	-117.9
Outlays	14.2	38.4	77.0
Military	0.0	-5.0	-10.0
Nondefense	-3.0	-11.4	-23.5
Federal Pay Increases	0.0	-0.1	-0.1
Subsidies	-2.0	-2.7	-3.5
Grants-in-Aid to State & Local Gov'ts.	-14.0	-27.3	-39.9
Transfers to Persons	4.8	8.1	0.0
Revenues	0.0	10.9	19.0
Tax on Motor Gasoline	0.0	3.0	4.0
Indirect Business Taxes & Nontax Accruals*	0.0	7.9	15.0
TOTAL	14.2	49.3	96.0

*Includes windfall profit tax on deregulated natural gas and excise taxes on items such as liquor and tobacco.

Table 23
"Tighter Fiscal-Easier Monetary" Policy Mix: $96.0 Billion Package of Higher Taxes, Lower Expenditures of DRI Interim Forecast (Changes Relative to Baseline Simulation "High Deficits")*

	Years		
	1982	1983	1984
Real GNP (% chg.)	-0.4	-0.7	-0.6
NIA Deficit (Bils. of $'s, SAAR)	16.0	52.5	97.5
Treasury Debt Issues (Bils. of $'s)	-21.5	-84.2	-204.0
Treasury Bill Rate (%)	-0.4	-1.4	-2.8
New Issue Rate on Corp. Bonds (%)	-0.2	-0.7	-1.1
U.S. Govt. Bond Rate (%)	-0.1	-0.5	-1.0
Mortgage Commitment Rate (%)	-0.1	-0.4	-0.9
GNP Price Deflator (%)	0.0	0.1	0.1
Consumer Price Index - All Urban (%)	-0.1	0.0	-0.1
Unemployment Rate (%)	0.1	0.3	0.6
Housing Starts (Mils. of Units, SAAR)	0.021	0.107	0.277
Business Fixed Investment (Bils. of 72 $'s, SAAR)	-0.3	-1.0	-1.3
Auto Sales (Mils. of Units, SAAR)	0.0	0.0	0.0
Personal Consumption Expenditures (Bils. of 72 $'s, SAAR)	0.1	-3.5	-10.5

*President Reagan is assumed to announce in January an ex-ante reduction in the federal budget deficit that reaches $96.0 billion by Fiscal 1984. Spending reductions of $77.0 billion and rises in taxes of $19.0 billion are recommended and approved. The comparisons are relative to a baseline simulation (High Deficits) that includes the current services federal budget consistent with the 1981 Reconciliation Act, the proposed 7% per annum real increases in military spending, and the provisions of the Economic Recovery Tax Act of 1981. No concomitant easing by the Federal Reserve is assumed.

While the assumptions on the reaction of expected inflation are somewhat arbitrary in these simulations, it does appear that a twist of policy toward "tighter fiscal-easier money" would help reverse the pessimism in the financial markets of this past summer and last December when possible deficits of $109, $152, $162 billion were leaked by the Reagan Administration. The financial markets, especially long-term bond markets, have been discounting the prospects of the Reaganomics fiscal stimulus and tight monetary policy into bond prices for quite some time. The rational expectation that the fiscal stimulus of Reaganomics would lead to inflationary pressures is consistent with history and represents a consensus view on the workings of the economy. That the supply-side view of the new policies was not the correct representation for the structure of the U.S. economy has been clearly indicated in the behavior of the bond markets, which provide a sensitive barometer for the expected rate of inflation. Bond yields have risen 100 to 300 basis points since December 1980, exactly the opposite from what might be expected if the "supply-side miracle" originally forecast by the Reagan Administration had, in fact, represented the way the economy actually worked.

Undoing the "loose fiscal-tight monetary" policy mix of Reaganomics should be the principal change to be made now in the new policies. Such action will be of major importance in relieving pressure on the financial markets and reversing the patterns of deterioration now in place for the U.S. economy. By increasing excise taxes, moving to "5-5-5" instead of "5-10-10", and reducing both nonmilitary and military spending, the Reagan Administration would go a long way toward rebalancing the imbalances in the economy from the current policy mix and also enhance the prospects for higher capital formation, productivity growth, and less inflation in subsequent years. Even without the assumed benefit to expected inflation from the announcement of a new turn toward fiscal restraint, the economy would be better off as a result of the tighter fiscal-easier monetary policy mix. There would be less benefit on long-term interest rates, wages, and inflation without a reaction in the expected rate of inflation to new fiscal restraint, but sharply lower interest rates still would alleviate the severe weakness in housing and other interest rate sensitive industries. A more balanced pattern of behavior in the economy would occur than currently is in place. Further, the severe financial strain plaguing much of the nonfinancial corporate sector, the state and local government sector, and thrift institutions would be eased and threats of widespread bankruptcy and failures would diminish.

Tables 24 and 25 summarize a smaller package of restraint, only $76.1 billion by 1984. Even this package is beneficial to the economy, in the sense of reversing the imbalances caused by severely tight money, because the fiscal restraint can be offset by an easier monetary policy.

Table 24
Somewhat Greater Fiscal Restraint

	FY82	FY83	FY84
	(Bils. of $'s, SAAR)		
NIA Deficit			
Ex-Ante	-117.4	-118.7	-130.6
Ex-Post	-115.6	-116.9	-111.8
Outlays	-7.2	-32.5	-57.1
Military	0.0	-5.0	-10.0
Nondefense	-3.0	-11.4	-23.5
Federal Pay Increases	0.0	-0.1	-0.1
Subsidies	-2.0	-2.7	-3.5
Grants-in-Aid to State & Local Gov'ts.	-7.0	-13.3	-20.0
Transfers to Persons	4.8	8.1	0.0
Revenues	0.0	10.9	19.0
Tax on Motor Gasoline	0.0	3.0	4.0
Indirect Business Taxes & Nontax Accruals*	0.0	7.9	15.0
TOTAL	7.2	43.4	76.1

*Includes windfall profit tax on deregulated natural gas and excise taxes on items such as liquor and tobacco.

Table 25
"Tighter Fiscal-Easier Monetary" Policy Mix:
$76.1 Billion Package of Higher Taxes, Lower Expenditures and M1 Growth at Upper Targeted Limits as Announced in January 1982
(Changes Relative to Baseline Simulation "High Deficits")*

	Years		
	1982	1983	1984
Real GNP (% chg.)	0.4	0.1	-0.1
NIA Deficit (Bils. of $'s, SAAR)	15.9	56.5	103.5
Treasury Debt Issues (Bils. of $'s)	-17.9	-85.0	-211.4
Treasury Bill Rate (%)	-1.6	-1.9	-3.7
New Issue Rate on Corp. Bonds (%)	-0.8	-1.0	-1.2
U.S. Govt. Bond Rate (%)	-0.5	-0.9	-1.3
Mortgage Commitment Rate (%)	-0.4	-0.7	-1.2
GNP Price Deflator (%)	-0.1	-0.2	-0.2
Consumer Price Index - All Urban (%)	-0.3	-0.2	-0.3
Unemployment Rate (%)	-0.1	-0.2	-0.2
Housing Starts (Mils. of Units, SAAR)	0.086	0.249	0.425
Business Fixed Investment (Bils. of 72 $'s, SAAR)	1.2	3.0	4.0
Auto Sales (Mils. of Units, SAAR)	0.4	0.5	0.7
Personal Consumption Expenditures (Bils. of 72 $'s, SAAR)	5.7	7.3	4.3

*President Reagan is assumed to announce in January an ex-ante reduction in the federal budget deficit that reaches $76.1 billion in fiscal 1984. Tax receipts are increased by $19.0 billion and spending reduced by $57.1 billion. The Federal Reserve provides the reserves necessary to raise M1 to its assumed upper target limits of 5.5%, 5%, and 4.5% for 1982, 1983, and 1984, respectively. The tighter fiscal-easier monetary policy mix is assumed to reduce the expected rate of inflation 1 percentage point by 1982:4 as the rational expectation to the changes in policy. The comparisons are relative to a baseline simulation (High Deficits) that includes the current services federal budget consistent with the 1981 Reconciliation Act, the proposed 7% per annum real increases in military spending, and the provisions of the Economic Recovery Tax Act of 1981.

In summary, with the financial markets reacting so negatively to prospects of large federal budget deficits time and time again, serious consideration must be given to changing the mix of stabilization policy toward a tighter fiscal policy. The damage to the U.S. economy from continuing unprecedented high levels of nominal and real interest rates can hardly be questioned now. Ways must be found to relieve some of the pressure created by the current squeeze without the central bank having to abandon its policy of gradual reductions in monetary growth.

INTEREST RATES

Representative **Reuss**. Thank you very much, Mr. Sinai, and thanks to all on the panel.

As is not unexpected, the experts disagree on various matters and perhaps in our questioning we can focus on those.

Mr. Bosworth, on interest rates, you testified, "I believe the low point of interest rates is behind us and continued increases in future months will severely restrain the anticipated recovery of homebuilding and automobile sales." Mr. Rahn, on the other hand, says, "Our forecast assumes a continuing and significant fall in interest rates."

Would you gentlemen like to interrogate each other to see if we can see the basis for your quite opposed predictions of what's going to happen? I'll ask each one of you, Mr. Bosworth, why do you think interest rates are not going to decline?

Mr. **Bosworth**. I think the basis of every economic forecast I've seen outside of the specific one mentioned here this morning shows a rising interest rate, that is if you look at the futures rate and the Wall Street Journal you will find that almost all the markets are projecting the short-term rates 6 months from now will be higher than they are today. I don't think there's any disagreement over this issue. This is the only forecast I guess I've heard of a significant decline over the remainder of this year in interest rates.

Mr. **Rahn**. Well, last spring we forecast a 16-percent prime. A lot of us were testifying before this committee. I was subject to some ridicule on that. We hit it within a quarter of a point.

Basically, in forecasting interest rates we are forecasting the behavior of the Fed, and if one assumes the Fed is going to radically increase the money supply, then of course you'll have higher rates. And I'm assuming Beryl Sprinkel and others are going to lean on the Fed for hitting on those targets. If they do and if the Fed gets that growth rate down, interest rates will fall as inflationary expectations fall.

MONETARY GRANTS

Representative **Reuss**. In 1981 the increase in the most common monetary aggregate, M_1, was 2.2 percent. That was below the Federal Reserve's target of 3.5 to 6 percent. Then as of this January 1, the Fed, under the prodding of the administration, reduced its targets to 2.5 to 5.5 percent.

Mr. **Rahn**. For M_1?

Representative **Reuss**. Yes. That looks to me as if they really are going to tighten the money supply, as if they're dissatisfied, understandably, that they didn't get within the target range of 3.5 to 6 percent last year, and they want to make sure they're in the ball park this year, so they have lowered the lower target to 2.5 percent. It looks, therefore, as if they know what they're doing. What they are doing is to tighten money even more excruciatingly than it has so far been tightened.

Now how does that behavior square with your prediction or hope or whatever it is that the Federal Reserve is going to increase the rate of M_1 at 5 percent in this coming year? If they increased it at 2.5 percent last year and go to all the trouble——

Mr. **Rahn**. I'm not talking about M_1.

Representative **Reuss**. It appears to me that they're not lowering their target just as an idle exercise.

Mr. **Rahn**. I would say that M1-B "shift adjusted" was below target. M_{1B} was near the high point of the target this past year. A lot of the problem——

Representative **Reuss**. No.

Mr. **Rahn**. M_2, excuse me, was near the high point. A lot of our problems——

Representative **Reuss**. Excuse me. Are you sure of that? The target for M_{1B} last year was 3.5 to 6 percent. They didn't hit it, the actual performance was 2.2 percent.

Mr. **Sinai**. It was below the lower limit. $M_{1\text{-}2}$ was somewhat above the upper limit.

Representative **Reuss**. You want to correct your testimony, don't you, about M_{1B}?

Mr. **Rahn**. No. Our foremost assumption is on M_1B they will hit 5 percent. A lot of our problem this past year was when we shifted the definitions with the new NOW accounts and the Fed has been struggling and they have had enormous difficulty determining what is the proper measure of money now. I think the real question is the rate of inflation. If the rate of inflation is higher than you want, I think almost by definition you have to say that the money supply is growing more rapidly than you want. We have had a very erratic growth in the money supply this past year, not as bad as 1980, and that erratic growth has also added to these interest rate premiums. We sort of look at what's happened. Interest rates have followed the changes in the growth rate of the money supply. It's no particular secret. When the money supply grew rapidly earlier in the year interest rates went up. After the money supply got down interest rates began to fall, and those interest rates have now begun to fall as money supply has grown rapidly again.

Representative **Reuss**. So it's the position of the U.S. Chamber of Commerce that you want the——

Mr. **Rahn**. If interest rates are too high, inflation is too high. We want to bring down the growth rates and we're not saying these ought to be fixed in concrete for all time, but you keep looking at it, and if we find we have a high level of monetary growth and high levels of inflation, we say slow it down. If it gets down too low—we had a period of time in the late summer of actually negative monetary growth which appeared to be too low. What it did then is help bring us into the recession. We have advocated all along a steady monetary growth rate, trying to get those targets down over the years to bring inflation under control.

Representative **Reuss**. Well, is it now your position that because inflation due to OPEC and a bountiful harvest and a——

Mr. **Rahn**. That's not what causes inflation.

Representative **Reuss**. That inflation is now higher than monetary growth? Is that your position?

Mr. **Rahn**. Our position—our judgment is now that if you have roughly a 5-percent rate of growth in M_{1B} over this next year and if it is steady that inflation and interest rates will continue to fall. OPEC and bountiful harvests have nothing to do with the rate of inflation. They do affect real incomes and they reduce real incomes, but inflation is a monetary phenomenon.

Representative REUSS. Would you agree, Mr. Bosworth, that oil prices and food prices have nothing to do with inflation?

Mr. BOSWORTH. No.

Representative REUSS. How about you, Mr. Sinai?

Mr. SINAI. No. The episode of severe inflation in the 1970's was primarily, according to a lot of scholars, supply-side shock oriented. A good deal of the inflation got into the U.S. economy that way.

ECONOMY IN 1981

Representative REUSS. Let me turn now to Mr. Evans. Mr. Evans, last year before this committee, in talking about the 1981 prospects, you testified and I quote:

> The U.S. economy is about to enter a boom of major proportions beginning in the second half of this year if the Reagan tax and spending package is passed. The major factors which will propel the economy into this orbit will be supply-side oriented.

In view of what happened after the Reagan tax and spending package passed, do you feel any different about supply-side economics than you did a year ago?

Mr. EVANS. I thought you might quote that. I remember that sentence well.

Representative REUSS. I quote it not to embarrass you because I feel different about supply-side economics now than I did a year ago. I thought it was bad a year ago. I think it's awful now.

Mr. EVANS. I think it's quite clear if one examines my forecast at the time that underlying my foolish forecast was an assumption that the Fed would basically accommodate the program, that we would see an expansion of money supply and reduction in interest rates. As it was, the Fed tightened further. We had virtually no growth at all in M_1B from April to October, the critical time when the program was being implemented, proving once again that monetary policy, if so desired, can always override fiscal stimulus. Even if we were to cut taxes and spending even further we still might end up in a permanent recession if the monetary authorities squeeze credit tight enough. So I think that it is somewhat of an error to blame supply-side economics—by that I mean the fiscal side of it, the tax cuts—for a monetary policy which was designed to clamp down on inflation at the expense of the real growth of the economy.

Representative REUSS. What you're saying then is that the Federal Reserve disappointed you, that they were too tight in their monetary policy, and that threw you off the supply-side expectations?

Mr. EVANS. That is correct. I also believe I made an error in assuming that the stimulus from supply-side economics would be immediate. I have previously written and testified in other places that supply-side economics takes 2 or 3 years to become effective, and when I wrote those immortal lines which you just quoted I was overly enthusiastic. So certainly my estimate of the timing that supply-side economics takes to become effective has lengthened.

FEDERAL RESERVE CHAIRMAN VOLCKER

Representative **Reuss**. With that kind of a point of view, weren't you horrified yesterday when the President at his press conference was asked about whether Mr. Volcker should be fired or not? After pointing out that technically he couldn't fire Volcker, nevertheless he expressed great concern about "an upsurge in the money supply just recently." That sounds as if the President is sharpening his axe for Mr. Volcker because Mr. Volcker isn't tightening money enough.

Mr. **Evans**. Well, I wouldn't use the word horrified.

Representative **Reuss**. What is your reaction to that?

Mr. **Evans**. I wouldn't use the word "horrified," but I was surprised. In my opinion, the increase in the money supply which has occurred during the past 3 months has been due largely to technical and seasonal factors and is not indicative of the underlying strength or growth of the money supply, and I think that a further tightening of the Fed at this moment would be a major mistake. So, to that extent, I was surprised by Mr. Reagan's answer.

TAX POLICY

Representative **Reuss**. Thank you. Mr. Sinai, in view of the recession or depression or whatever it is that we're in, would you think it would be a good idea to increase excise taxes now? By excise taxes, I mean everything from beer, liquor, tobacco taxes to some sort of a value added sales tax.

Mr. **Sinai**. Yes. I think the budget has to be moved to a more restrictive position one way or the other. We have always been very positive about the business tax cuts in the sense they would be the least inflationary. They would generate capital formation; but with some very long lags. Those tax cuts won't really have an impact until later years and shouldn't be touched. But I think everything else ought to be open for scrutiny. Excise taxes, in a sense, are a consumption tax for some and would go some distance toward reducing the rate of consumption and increasing the rate of saving. That certainly is a candidate now. So my answer is, yes, they should be increased.

I might add, the reason, as we all know, that we are in this situation is because of the legislated large cuts in taxes that were passed this past summer. The big element was the personal income tax cuts, and aside from the fact that the President is so adamant on not changing it, the single most constructive move in fine tuning the tax program would be to do something about 5-10-10, either making it a 5-5-5 and preserving the initial thrust of it which I support in terms of reducing marginal tax rates over time, or postponing or delaying the third stage. That really is where the biggest bang for a buck of effect on the financial markets would come from in the tax area.

Now if you assume you can't touch personal income taxes, the next place to look is excise taxes.

Representative **Reuss**. Mr. Evans made a point with which I find myself in complete agreement. He says in his prepared statement that "An area where taxes could be raised is the rescission of the swapping of investment credits." He goes on to say, "While this newest tax benefit has some minor impact on investment, it's much less efficacious than the reduction in the depreciation lives or a cut in corporate income tax rate. It also has the unfortunate side effect of subsidizing the losers at the expense of the winners, thereby distorting and misdirecting capital market flows." I find that an extraordinarily cogent statement. Do you agree with Mr. Evans that one way of getting budgetary control that wouldn't have untoward side effects would be the prompt rescission of that investment tax credit swapping?

Mr. **Sinai**. Like any economist, I always hate to agree with another economist, right? Economists always disagree. But I think the purpose of the accelerated depreciation was not just to stimulate capital formation but to provide some tax relief, and the tax legislation does discriminate against those firms that don't make profits. The swapping has been a way for those firms to get some benefit from the tax cut and I find myself generally in favor of the firms who can't use the tax benefits because they have no profits—it has no effect on them in capital formation since no advantage can be taken. But other than that, I would say that since we are in big need of raising revenues, I would agree with Mr. Evans, that's a good place to look for revenues.

Representative **Reuss**. Mr. Bosworth, what's your view on that question?

Mr. **Bosworth**. Basically, I would agree with Mr. Evans.

Representative **Reuss**. Mr. Rahn.

Mr. **Rahn**. I would disagree. I would be unhappy with any tax increase at the moment and I think we ought to talk a little bit about political reality. Some of us were watching the Ways and Means Committee very carefully when that came about and it was clear the Congress was going to do something about the distressed industries—Chrysler, International Harvester, and many of the others—and there were a number of proposals set forth and, in my judgment, most of those, if not all those competing proposals, had a far more negative impact and would have been far more costly for each dollar lost for the Treasury than the one we're discussing. If we're talking about an ideal world in which Congress would not have done anything for the industries that were distressed, we might come to some different conclusions, but I think we have to put it in the realm of the decision that was faced by Congress at the time and I think Congress selected the best alternative.

Representative **Reuss**. Thank you.

Mr. Richmond, I have to go. So I would hope that you would take as much time as you want and conclude the hearing, and I want personally to thank the members of the panel for a memorable contribution.

DEFENSE SPENDING

Representative **Richmond** [presiding]. Thank you, Mr. Chairman. Good morning, gentlemen. Can we agree on one item before we go on to what we disagree on? Can we all say this entire distinguished panel believes we ought to cut defense spending selectively over the next few years?

Mr. **Rahn**. You're talking about cutting the growth rate?

Representative RICHMOND. We ought to reexamine the expenditures of the Pentagon and remember when Mr. Weinberger came before the Senate for his confirmation hearings when he himself said that there was about $10 billion worth of waste in the Pentagon. Anybody who does $240 billion worth of business must have more than that, yet our President insists he doesn't want to cut defense by one penny. Do we all say perhaps the Pentagon ought to be reexamined to see how much waste we should get out of the Pentagon?

Mr. RAHN. Yes.

Mr. BOSWORTH. Yes.

Mr. EVANS. Yes.

Mr. SINAI. Yes.

1982 ECONOMIC RECOVERY

Representative RICHMOND. I'm glad we agree on something.

Mr. Rahn, in your prepared statement you say the economic recovery will be well underway by the second half of 1982. Then you say that we expect the recovery to begin as early as the first quarter of 1982. Here you're a senior member of the U.S. Chamber of Commerce. I'm sure you're privy to many, many corporations' financial statements. I wonder where you get that feeling. You know, for example, that John Deere, the No. 1 farm equipment firm in the world today, is closed for the month of January? Many, many other companies are literally on half-time, quarter-time, or also partially closed for the month of January. Companies were closed for the month of December.

How can you possibly say that the economy is going to start improving in the first quarter of 1982?

Mr. RAHN. Times are bad. We are in a deep recession. Nobody denies that. When you're in a deep recession, every time you have to ask, why would you come out of a recession? Why have we come out of the recession in the past? Well, there are certain animal juices that tend to bring us out, but for this recession for the first time we have, whether you're a Keynesian or a supply-sider as I am—that's one thing we both agree on—that you cut taxes during a recession. Taxes are being cut during the recession.

That was not the original point of the package, but that is what is happening, and you can find no more propitious time to cut taxes than right now. And over the next few months tax rates will indeed come down in much of the productive sector. Given that and given that we do indeed come out of recessions as a natural course of events and this time around policy is correct for bringing us out of a recession, I expect a strong bounce back.

You might remember in 1980 we had that sort of a "V"-shaped recession. We went into a very, very steep one and things looked very, very bad and all of a sudden things improved very quickly.

Representative RICHMOND. Mr. Rahn, it's not going to happen this time. You have a few major areas of American industry—the automobile, for example. My feeling on the automobile is that the average car on the road now is 7 years old and there will be increased sales in the automobile area due to the need for replacement.

Mr. **Rahn**. We have a tremendous pent-up demand as interest rates come down.

Representative **Richmond**. But interest rates are not coming down. You and I know that.

Mr. **Rahn**. I don't know that at all. Last spring I forecast the prime interest rate at 16 percent before this committee and a number of people on the committee—I don't believe you were here, Mr. Richmond—but some others said, no, they're not going to come down and so forth. Well, they came down and I'm confident they're going to come down again.

Representative **Richmond**. I think your other three associates and I agree that the trend is up for the interest rates. I think we have seen the bottom at 15 percent.

Mr. **Rahn**. And I think they're wrong and at some point in the future we'll know.

Representative **Richmond**. Let's say the chance for automobiles to have a somewhat better year than they did last year is there because the average car on the road is 7 years old and people are just going to have to replace their cars. Then you get into housing, which is by far the biggest industry in the United States. As you know housing affects trades, appliance firms, and all the rest. So you would have to say, next to agriculture, the housing industry is by far the largest industry in the country. With interest at 17 percent, I can't for the life of me see how housing starts are going to increase to anything enough to get this economy going again in the foreseeable future.

Mr. **Rahn**. If interest rates stay at 17 percent, mortgage interest rates, you're absolutely right. But, again, I'm expecting they're going to fall.

Representative **Richmond**. And I'm expecting they're going to increase and I'm sure many of your fellow economists here agree with me.

Mr. **Rahn**. There's a number of economists that agree with me and at some point this will be determined, and we're debating about the unknown at the moment and we have various judgments.

Representative **Richmond**. Then your third area of farm equipment. Farm equipment is dead, as you know, because the farmer just doesn't have the money to buy new equipment with commodities at an alltime low. The price of commodities in the United States, if you indexed them back to the Depression, would be considerably lower now than they were during the Depression. Corn is at $2.50 a bushel. If you index that back to the Depression you will find it's cheaper now than what it sold for during the Depression. So I don't see how the farmers are going to survive, let alone buy new equipment. Here you have all the major areas of the United States—automobiles, housing, farming equipment—all these gigantic industries that literally can't do very well over this coming year.

Now for you to say the economy is going to change in the first quarter of 1982 is laughable.

Mr. **Rahn**. Well, I guess we'll see.

Representative **Richmond**. No, Mr. Rahn, you don't see, because I have a company that makes products for the automotive industry and for the appliance industry and for the agricultural equipment industry. Our orders come in 6 months before their orders come in and I can tell you that our backlogs are lower than they have ever been in modern times. That means only one thing to me. It means that this year is going to be one of the poorest industrial years in the history of the United States. I think all of us ought to recognize that and try to do something about it instead of paving it over and saying it's not going to be a poor year.

Mr. RAHN. It seems to me you're ignoring the effects of the tax rate reductions.

Representative RICHMOND. The tax rate reductions only help very rich people.

Mr. RAHN. That is just not true. Those tax rate reductions help people up and down the income scale. If we didn't have those tax rate reductions coming into effect now, I would be very depressed. I would see a long period of economic stagnation and a much deeper recession.

TAX INCREASES

Representative RICHMOND. Well, I do see a long period of economic stagnation and a deeper recession and more inflation because of the various problems in the United States today.

Mr. RAHN. Well, we ought to speed up the tax rate reductions.

Representative RICHMOND. No. In my opinion, we ought to speed up balancing the budget. That would be the most sensible thing to do.

Mr. RAHN. How are we going to do that? Cut spending more?

Representative RICHMOND. There's a limit on cutting spending, but we can certainly levy 44 billion dollars' worth of "share the burden" taxes.

Mr. RAHN. So you want to increase taxes?

Representative RICHMOND. I want to get the American people to pay their own way. Those people who use our waterways should pay a user fee. Those people that use commercial planes in our airports should pay a reasonable fee. Those people who need assistance for their 80-foot yachts ought to pay the Coast Guard for the privilege. Consumer interest rates should not be tax deductible other than for your first house and first car. If you just applied reasonable business methods to our Tax Code I believe we could pick up 44 billion dollars' worth of income. That's $44 billion. If we just went into the Pentagon and cut out some of the waste and cut out some of the duplication you would certainly have another $20 billion there. And then if we once got the message across to our Japanese allies and got them to equalize what is now our deficit of trade you've got another $30 billion. So using very sensible business methods, we could virtually balance the budget this year. That's what I feel is the way to get this country back on the track again.

Mr. RAHN. I agree, a lot of changes ought to be made in the Tax Code. I think we ought to restructure taxes somewhat. But in terms of having aggregate tax increases at the bottom of the recession, I would think that would only add to our problems and not alleviate them.

Representative **Richmond**. How about the fellow who owns a 100-foot yacht and has to be towed in by the Coast Guard? Do you think he has a right to call the Coast Guard and get towed in for nothing?

Mr. **Rahn**. I agree since I don't own a 100-foot yacht. We have been trying to have the lowest across-the-board rates possible with the least number of exceptions.

Representative **Richmond**. Mr. Rahn, if we just charged people for using the Coast Guard services, we would pick up $60 million. Just think of what that $60 million could do toward helping some very necessary programs that are being cut out now, like day care. If we just asked the Mississippi waterway people to pay their own fee for cleaning up the waterways, we would pick up $516 million. I have a total here of $44 billion that we could easily pick up from user fees. If you want to smoke and drink, more than likely you're the people who are going to be in the hospitals. Don't you think it's very logical to charge a super excise tax on people who smoke and drink because they require more hospitalization than people who don't?

Mr. **Rahn**. You have to look at the negative ramifications on that tax. Personally, I don't smoke and I don't care if we had higher taxes on cigarettes or not. But if you start increasing those taxes without reducing others, then you're going to have problems in terms of turning around the economy. Those taxes lead directly to inflation the way our CPI is calculated, and I think we have to be careful and look at the ramifications.

Representative **Richmond**. It wouldn't go into inflation because they would be deflationary because they serve to reduce the national deficit. What about your highway user tax?

Mr. **Rahn**. Reducing the deficit now is not going to bring down either inflation or interest rates.

Representative **Richmond**. Reducing the deficit is the quickest way, Mr. Rahn, to reduce the deficit, reduce interest rates, and get this country back on the road again because as long as you have hundreds and hundreds of millions of dollars of Treasury bonds overhanging this market, which have to be sold on auction on a very timely basis, there's no way you're ever going to reduce the interest rate and reduce inflation.

Mr. **Rahn**. The size of the deficit is important in relation to the net amount of savings in the society. Again, let me reiterate——

Representative **Richmond**. The net amount of savings in the United States is at an alltime low. In addition, the savings are not in long-term savings accounts. That's something I would also like to bring out this morning. The quality of American savings, even though they're terribly low, are considerably worse than that because many Americans are saving their money in certificates of deposit, short-term Treasury bills and what have you which really aren't savings. They're just temporary transfers of money.

Mr. **Rahn**. You're telling me CD's are not savings?

Representative **Richmond**. I say CD's are not savings. When you're buying a CD for 10-, 12-, and 14-percent interest, a 6-month CD, I call that investing. Until we reduce inflation and interest rates, we cannot increase real savings in the United States and I don't call a CD or a Treasury bill real savings.

Mr. Rahn. Well, then, we have a fundamental disagreement. The IRA accounts which the Congress wisely put in I think are the first step toward moving us to encouraging long-term savings. I, personally, and as an economist, and the chamber for a long time have advocated changes in the tax law to take away the tax bias against savings so we would increase the savings rate like the Japanese who have grown rapidly, and I agree with you that we have to increase long-term savings.

Representative Richmond. We have to increase the whole concept of savings. You will never increase the concept of savings at reasonable interest rates until you bring down the total cost of interest. You're not going to bring down the total cost of interest until this Government stops printing Treasury bonds. You're not going to stop printing Treasury bonds until you reduce the deficit.

Mr. Rahn. I have never been an advocate of deficits, but the question is, how do you eliminate the deficit? And I say the way you eliminate it is to——

Representative Richmond. You eliminate the deficit which could be done this year with $44 billion of share-the-burden fees, $20 billion coming out of the Pentagon and $30 billion from getting trade equity from Japan which would get our Government on a pay-as-you-go basis. You know what that would do to interest rates? Drop them by half. Do you know what that would do with the general feeling in the United States? People would go out and buy things because people would realize they have an extremely stable government. Just by taking three very practical measures we could accomplish that.

Mr. Rahn. You think that $44 billion tax increase would have no negative effect on income, on growth?

Representative Richmond. It would have a positive impact because in our proposed tax increase we allow $11 billion for increasing our excise tax on gas alone. That money would immediately go into improving the highways and bridges in the United States which are in deplorable condition. Congressman Howard, the chairman of the Public Works Committee, estimates that 178,000 bridges in the United States are——

Mr. Rahn. Then you're going to be spending by the amount you reduce the taxes.

Representative Richmond. You're going to increase spending in improving your highways and bridges.

Mr. Rahn. So we're going to have additional spending; is that right?

Representative Richmond. Which, in turn, will reduce the cost of operating your automobiles, will reduce fuel usage, make our highways and bridges a lot safer. You're confronting right now a situation where our bridges are virtually at a stage of collapse so many of them were built under WPA under President Roosevelt.

Mr. Rahn. I say there's a very good case for increasing spending on highways and bridges. Where is that money going to come from out of the budget?

Representative Richmond. Out of getting the people who use the highways to pay for improving their own highways and their own bridges.

Mr. RAHN. So we're going to increase the total Government spending?

STOCK PRICES

Representative RICHMOND. You would have a certain lag time so you could at least be able to bring the deficit down for a while and then you would increase spending before our highways and bridges really cause disasters in the United States. But these are things that have to be done. I think they are things people would like to see done.

Mr. Evans, I don't want to belabor the case with you, but you and I had a chat on Monday, February 23, about the stock market and you said, we're doing quite a bit. I think the stock market is poised for a major takeoff, and if you want to forecast that, go ahead; but it's not my forecast. I wouldn't call the Kemp-Roth tax a little tax. Most people who criticize it say it's not large enough.

Well, Mr. Evans, we're here a year later and you and I had a lengthy dialog a year ago and I pointed out that in the last 15 years the stock market has done nothing and you disagreed with me. How do you feel about it now?

Mr. EVANS. I think it's clear the stock market has gone down over the past year and I attribute that to the recession that we're in and I also attribute that to the fact that interest rates on balance went up most of the year. They have come down a little bit in the fourth quarter, but on balance they are a lot higher than I expected. So my forecast for real growth was too optimistic and my forecast for interest rates were too low, as Mr. Reuss has already mentioned.

Representative RICHMOND. What's your present forecast?

Mr. EVANS. For what?

Representative RICHMOND. For the stock market for another year? We'll be back in another year, God willing.

Mr. EVANS. I think the stock market——

Representative RICHMOND. That's if you keep your job and I get myself reelected we'll be back in another year.

Mr. EVANS. I won't comment on either of those, but as far as the stock market goes, I think it will rise about 20 percent. So it would be about 20 percent higher when we reconvene next year.

Representative RICHMOND. Let me go on record as respectfully disagreeing with you because I don't see it happening, not with hundreds of billions of Treasuries hanging over the market this coming year. And I don't think it's the fault of the Federal Reserve Bank or the fault of the availability of money that's destroying the country. I think it's the fault of this enormous deficit that we have to pay interest on every couple of weeks. We don't have orderly savings the way they do in Germany and Japan. I believe deficits are just fine if they can be paid with low-cost money. The deficits are not fine when you have to pay them at the rate of 15 percent.

JAPANESE ECONOMIC PERFORMANCE

Mr. Sinai, I was particularly interested in your testimony. What's your feeling about the lack of inflation in Japan and the fact that they're able to function on 5.25 percent interest rates?

Mr. **Sinai**. Well, there are probably a lot of reasons. The one that strikes me is that they really do have a different system of management and the Japanese worker seems to be a great deal more productive, and the numbers show that, than American workers, and their management structure is quite different.

Representative **Richmond**. Mr. Sinai, the American worker is still more productive per capita than the Japanese worker.

Mr. **Sinai**. I'm talking about aggregate productivity which has been very weak in our country relative to those of the countries of the rest of the world. I'm not criticizing American workers. I was trying to be very careful in my choice of language.

Representative **Richmond**. Productivity will be down because any time you have a factory where the workers know the work is going to slow down they're going to slow down. In Japan the volume keeps going up, therefore, the workers have had a lot of work to look forward to—overtime and permanent employment and all that. You only have overtime and permanent employment when your volume keeps going up.

Mr. **Sinai**. One element I would point to is that they do have a more participatory set of policies and the workers seem to have a little more incentive and they also have a better savings rate than we do, but I'm not that familiar with the incentives to save in Japan compared to this country. We have had a high pressure economy for many years aimed at full employment and not aimed at generating enough savings to support the kind of capital formation that's necessary for long-run strong productivity growth. I think we are now in a transition and moving to that, but we are still a good deal away from it.

FEDERAL BORROWING

Representative **Richmond**. Mr. Sinai, would you feel some of our problems perhaps right now could be traced to the fact that we have to have these constant auctions of Treasury bills and Federal Reserve policy?

Mr. **Sinai**. I think there's something new going on in the financial world that most people miss except those that are very close to it. It fundamentally results from the Federal Reserve policy but any source of demand on the financial markets, including the Treasury demand for funds, will have a bigger impact on interest rates now than ever before. With interest rates free to move under the new policy, they will be more volatile and a bigger risk premia will be necessary than ever before. The higher interest rates will restrain activities like housing and capital formation and have negative effects in the long run on the economy.

This is new and I think we should not expect to get bailed out in the future by anything the Fed will do unless they radically change their policy. So long as it is in place we will have a world of much more volatility, much higher interest rates, a set of financial markets that will be very sensitive to the deficit, and we will have to be tougher on the deficit than ever before in order to keep interest rates at more reasonable levels.

WAGE-PRICE CONTROLS

Representative Richmond. Mr. Bosworth, a year ago we discussed the advisability of price and wage controls. How do you feel about that now?

Mr. Bosworth. I think now there's probably no reason to talk about them. The current administration is opposed to any measures like that. I think the 1972 and 1973 experience taught us that whatever we may feel about the issue, that if the administration currently in charge doesn't want them they can destroy and render ineffective any program that would be put in place. So I don't think it's likely to happen in the current period and I don't think we have the necessary conditions where the administration will want to go that route and, therefore, to talk about them is probably just unduly speculative.

Representative Richmond. I would also say the amazing unforeseen cooperation of the labor unions in recent months obviates the necessity of wage and price controls too. I never in all my years of business have seen unions so willing to renegotiate their contracts in order to make their companies more profitable.

Mr. Bosworth. I think something has changed.

Representative Richmond. That's a phenomenon.

Mr. Bosworth. One of the phenomena is that the unemployment rate is now up to 9 percent in these industries where these changes are occurring. Remember, they are not average. They are industries that have gotten in extremely critical conditions such as the automobile industry.

Representative Richmond. And the farm equipment business and the appliance business and the housing industry and the States of Oregon and Washington that live on timber that are virtually declaring a state of emergency now. I don't think anybody really understands how terrible the conditions are in many, many areas of the United States.

Mr. Bosworth. I would agree.

CAUSE OF THE 1981 RECESSION

Representative Richmond. This is the last question. Do you all have any sort of answer of what caused the 1981 recession?

Mr. Sinai. The 1981 recession, I believe, came from a very tough and tight monetary policy in terms of the levels of nominal and real interest rates and not very much fiscal stimulus. Fiscal stimulus in the Reaganomics program really comes on board mainly in 1983 and 1984 and perhaps in the second half of 1982. The very tight monetary policy simply swamped anything on the fiscal side and drove the economy down.

Representative Richmond. Then you feel it's going to improve when?

Mr. Sinai. We're projecting a slight upturn in the second quarter and then for the economy to pick up steam in the second half, but I want to clearly point out that our forecasted expansion rate is considerably lower than what we have had in most expansions coming out of this kind of slack position for the economy. It is so because of the particular twist of policy that is now in place.

Representative **Richmond**. I would like to go on record as saying that I will be quite happy if the year 1982 is anywhere near as good as 1981.

Mr. **Sinai**. Our forecast for 1982 is for real GNP to be down for the year by about one-half of 1 percent or, six-tenths of 1 percent.

Representative **Richmond**. Therefore, more than likely, we are not coming out of the recession.

Mr. **Sinai**. Yes. You know, this is an average for the year and you can have differences in quarters. We do think you also should remember that these growth rates are going to be misleading because it's hard to see how housing could get much worse or automobiles could get much worse or the industries you named or I named could get much worse.

Representative **Richmond**. Mr. Sinai, with interest at 17 percent, who do you know that can afford to buy a house?

Mr. **Sinai**. I know some people.

Representative **Richmond**. Not many. You have to have an income between you and your wife of more than $40,000 before you can even think of buying a house at that interest rate.

Mr. **Sinai**. The point I'm making is even if the economy should pick up steam, which I think most of us are forecasting later this year, we are picking up steam from a very, very low level of operation and good growth rates may not be signs that the economy is healthy because those growth rates will be coming off a base that will be the worst of the postwar period, the lowest of the postwar period.

Representative **Richmond**. Mr. Rahn.

Mr. **Rahn**. Well, the recession came about from excessively high rates of inflation and the interest rates we had from 1980 going into the year, the erratic Fed policy, and the great increase in tax impediments that we had over the year and the crowding out of excessive Federal spending.

Representative **Richmond**. And now?

Mr. **Rahn**. Now we can see a turnaround as early as the end of the first quarter of this year, March, slow growth up through the middle of the year, picking up steam. So the total year won't be all that great, about a 1.2-percent increase, year over year.

Representative **Richmond**. All I can tell you, Mr. Rahn, is that you talk to some of your members and see if they agree with you, because I can tell you in my company we make basic forgings and forgings usually come about 6 months before the final product and our forging orders have been down lower than they have been in years.

Mr. **Rahn**. We talk to our members daily and have constant discussions with them, and the message I keep getting back is stick with the President's program; it is our only way out.

Representative **Richmond**. Would you say Caterpillar is probably one of the finest companies in the United States?

Mr. **Rahn**. Yes.

Representative **Richmond**. Caterpillar is absolutely flat out and has no idea whether their volume will——

Mr. **Rahn**. And they think we ought to stick with the present program.

Representative **Richmond**. I'm not telling you what the Caterpillar Co. is saying. I'm telling you about Caterpillar itself. Caterpillar has such a high inventory and low demand—it's certainly one of the finest companies in the world, not only the United States.

Mr. **Rahn**. I think Caterpillar is a fine company. Their management and the management of most of the other industrial companies is telling us to stick with the President's program.

Representative **Richmond**. Well, I respectfully disagree with them because the President's program is getting us nowhere. Mr. Evans.

Mr. **Evans**. As I said in my prepared statement, I think the proximate cause of the recession was the tight monetary policy and high interest rates. In the third quarter of 1981 we had a real interest rate of approximately 10 percent, whereas historically the real interest rate has been approximately zero for short-term rates and 2 or 3 percent for long-term rates. We also had an economy which was fragile and has been weakened from the recessions in 1979 and 1980. We also had a tax increase of approximately $40 billion that went into effect in 1981. I think all these factors contributed, but the major one was the tight monetary policy.

As far as my forecast for 1982 goes, basically, I'm not very optimistic about the year, as I testified. I think we will have very little growth in the first half of the year. I think the second half of the year growth rate will be about 2 or 3 percent, as I do see some recovery in autos and housing from very low levels, but I do see some recovery, and I look for 1983 then to be a stronger year.

Representative **Richmond**. Thank you, Mr. Evans. Mr. Bosworth.

Mr. **Bosworth**. I didn't hear anything said by Mr. Sinai or Mr. Evans with which I would disagree.

Representative **Richmond**. So you look to a rather flat first half for 1982 and you feel we're going to improve in the second half of 1982?

Mr. **Bosworth**. Yes.

Representative **Richmond**. And come out of this recession in 1983?

Mr. **Bosworth**. That's a long way in the future. That depends on what's going to happen with monetary and fiscal policy this year.

Representative **Richmond**. How do you feel about some of these suggestions I've made for balancing the budget, such as $44 billion share-the-burden taxes, getting the Japanese to give us a fair shake, and cutting $20 billion out of defense?

Mr. **Bosworth**. I think that's the list of items that's going to have to be considered. I think it's more straightforward perhaps to act within the income tax but there are political problems with that. I think the excise taxes that you list are going to have to be on the agenda for increases in 1983 and 1984.

Representative **Richmond**. And also removing the tax deductibility of second houses and planes and yachts and all of the other luxuries that people borrow money for?

Mr. **Bosworth**. I think if we can get people to understand the implications, that moving toward a tax system that limits deductions for interest payments would be a good idea.

Representative **Richmond**. Thank you. Any further comments, gentlemen? [No response.]

Thank you very much for coming. It's a pleasure having heard all of you and certainly I'm going to read your testimony very carefully.

The committee stands in recess.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, January 26, 1982.]

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 26, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Long, Richmond, Heckler, Rousselot, and Wylie; and Senators Abdnor, Symms, Mattingly, Bentsen, Proxmire, Kennedy, and Sarbanes.

Also present: James K. Galbraith, executive director; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, assistant director; and William R. Buechner, Kent H. Hughes, Paul B. Manchester, Deborah Matz, Mark R. Policinski, Douglas N. Ross, George R. Tyler, Richard Vedder, and Robert E. Weintraub, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order.

We are delighted this morning to welcome the Honorable Paul Volcker, Chairman of the Board of Governors of the Federal Reserve. Mr. Volcker, I want you to know that the members of this committee feel honored and delighted to have you here with us today, as we always do, despite indications in the press that you may not be quite as welcome in some other parts of town as you are here. You and I and members of this committee have had our differences over the course of monetary policy, but when we differ you don't call for my impeachment, for which I thank you, and I don't call for your resignation.

Recently, the administration has been engaged, as you know, in an underhanded effort to disassociate itself from the monetary policy conducted in 1981 by the Federal Reserve. The purpose of this effort is to create the impression that the administration does not support your policy of tight money and high interest rates, and indeed that it never did support such a policy. Congressman Jack Kemp has called for your resignation. The President, when asked last Tuesday to comment on Mr. Kemp's demand, conspicuously evaded the question.

I find this behavior distasteful. For it is the President who has consistently called on the Federal Reserve to tighten money and raise interest rates, and he stands as responsible for the errors of policy in 1981 as the Federal Reserve.

You may recall that strong statement of David Stockman and Jack Kemp in their famous Dunkirk memorandum of last year:

> President Reagan should meet with Volcker or the entire Federal Reserve Board at an early date and issue them a new informal "Charter"—namely, to eschew all consideration of extraneous economic variables like short-term interest rates, housing market conditions, business cycle fluctuations, etc., and to concentrate instead on one exclusive task: bringing the growth of Federal Reserve credit and bank reserves to a prudent rate and stabilization of the international and domestic purchasing power of the dollar.

Thus spoke Stockman and Kemp. You may recall also the directive in the President's Economic Recovery Program of February 18, 1981: "To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986."

There would be something admirable about a President who, having issued such a directive, would then have boldly told the American people that he supports tight money and high interest rates regardless of the misery they cause, the unemployment and bankruptcies. But I find nothing particularly admirable about a President who instigates a policy of tight money and high interest rates and recession, and then seeks to escape the blame for the consequences of that policy by passing the buck to the Chairman of the Federal Reserve Board—that is reprehensible.

A poet has best expressed your attitude and that of the President concerning tight money and its consequences to human beings in the killing of jobs and businesses:

> "Yet each man kills the thing he loves,
> By each let this be heard,
> Some do it with a bitter look,
> Some with a flattering word.
> The coward does it with a kiss,
> The brave man with a sword."

I hope that you find some consolation in these lines.

I now would like to stress that, although I don't hold the Federal Reserve uniquely and solely responsible for high interest rates and the recession, I strongly disagree with the present thrust of monetary policy. Last year, the Federal Reserve set a target for M_{1B} of 3.5 to 6.0 percent, and then dramatically undershot that target, achieving an M_{1B} growth of only 2.2 percent. That was too tight. This year, if the FOMC confirms the tentative decision already reached, you will be lowering the target ranges so that the floor is only 2.5 percent. That will send a clear and unwelcome signal that you plan to continue a supertight monetary policy this year, frustrating the hope for recovery of housing, automobiles, farming, small business, and productive capital investment. I urge you not to send that signal next Tuesday, and instead to vote to maintain the monetary targets for 1982 at their 1981 levels.

Senator Mattingly, did you have a statement?

OPENING STATEMENT OF SENATOR MATTINGLY

Senator **MATTINGLY**. Thank you, Mr. Chairman. I don't have any poetry to offer you this morning. I didn't find much poetry when I went home.

It's a pleasure, as always, to see you, Chairman Volcker. I welcome you to our annual hearings on the economic outlook. Your appearance is especially timely because recent monetary developments are, to say the least, puzzling, troubling, and disappointing.

I am sure that you know that I am referring to the incredible jump in the conventionally defined money stock, M_1, since last November, and the increases in most interest rates that followed quickly, beginning in December. It would appear that Volckerism has become synonymous with erratic and inconsistent money supply.

I hope you will explain why you allowed these changes to take place. Surely, you at least could have prevented the jump in M_1 growth. You could have done so by reducing the supply of reserves to the banking system by however much was necessary. If withdrawing $1 billion in reserves would not have done the job, you could have withdrawn $2 or $3 billion, or whatever amount was necessary. In fact, you supplied new reserves to validate the new money growth. I know withholding reserves would have raised the Federal funds rate during the late November-early January period, but keeping it in the 12 to 13 percent range during that period did not keep other interest rates from rising and indeed now the Federal funds rate has to rise and it is rising.

What constructive purposes were served by your policy actions—keeping the Federal funds rate relatively constant and letting M_1 growth soar—in recent months?

More broadly, what constructive purposes are served by volatile M_1 growth? What's been the good of letting M_1 grow 7.8 percent per year from 1977 to 1980, dropping it below zero in the January to April 1980 period, accelerating it to nearly 11 percent from April 1980 to April 1981, the highest 12-month rate since World War II (and at an even higher annual rate—13.3 percent from January to April 1981), then stopping it all together from April until October 1981. And, then increasing it once more to over 20 percent per year beginning last November. What have you been trying to accomplish?

Whatever your motives, what rollercoaster money growth around high average growth has helped to achieve is this:

One, you achieved the preservation of high inflation, high inflationary expectations and high interest rates. You have reduced money growth from time to time, but you have not kept it down. It must be kept down to stop inflation, dissipate inflationary expectations and permanently reduce interest rates.

Two, you produced or exacerbated recessions, for every now and then you clamped on the brakes, as for example in early 1980 and again between April and October in 1981.

Three, you produced more uncertainty and hence more volatile interest rates and an increasing reluctance by the public to lend for long periods.

Why can't you produce steady sustainable noninflationary money growth? Are your tools not adequate? What new tools do you need that Congress can give you? Are your own procedures adequate? Many economists think they are not. They point out, for example, that M1 growth was much smoother and less inflationary from 1956 to 1967 when you required banks to match reserves against their current deposit liabilities than it has been since 1967 when you allowed reserves to be matched against deposits of 2 weeks ago.

Chairman Volcker, your appearance here is timely. Recent monetary policy, or Volckerism, as I said, has been puzzling, troubling, and disappointing. Perhaps you can convince me it is not your fault. However, I would rather be persuaded that your future performance will be understandable, calming, and pleasing. I am glad you are here.

Representative REUSS. Representative Wylie, do you wish to say any words of welcome?

Representative WYLIE. Thank you very much, Mr. Chairman, for asking me. I don't have an opening statement. I'm rather anxious to hear from Mr. Volcker at this point. Thank you.

Representative REUSS. All right. Thank you, Congressman Wylie.

Senators Abdnor, Hawkins, and Bentsen have requested that their opening statements be included in the printed record, which I will do at this point, without objection.

[The opening statements of Hon. James Abdnor, Hon. Paula Hawkins, and Hon. Lloyd Bentsen follow:]

OPENING STATEMENT OF SENATOR ABDNOR

I am pleased to join my colleagues in welcoming you to this hearing, Mr. Volcker.

As a spokesman for the agriculture sector of our economy, I realize both the contribution this sector makes to the overall economy and the particular dependency this sector has on credit conditions.

Assets in agriculture now amount to almost $1 trillion, nearly 90 percent of the value of all manufacturing assets in the United States. Debt amounts to around $200 billion. If that was financed at, say an average of 10 percent, the service on that debt would be $25 billion annually, which is roughly equal to net farm proprietors' income. It alarms me that the cost of credit could be such a high figure relative to income. Over the past 25 years, the AG sector has undergone a heavily capital-intensive transition, adding great burden to new entrants to this industry.

Our highly productive and efficient agriculture sector distribute benefits to all other sectors. On the macroeconomic level, our exports result in a $29 billion net trade surplus in agriculture, making it the largest positive net contributor to our balance-of-payments problem. Needless to say, this contribution has a tremendous impact in terms of direct and indirect spending effects.

While this export business is extremely valuable, our food growers have produced an apparent surplus and prices have plummeted in the past year. As a matter of fact, while the overall producer price index increased slightly last year, the grain index dropped 12 percent, livestock went down 14 percent, and other AG commodities fell as well. While wages and salaries increased 10.4 percent and transfer payments were up 13.2 percent in 1981, farm proprietors' income fell almost 6 percent from the previous year's low level. Incidentally, this income category was the only major one to decline in 1981.

A paradox is revealed in noting that the portion of income devoted to food purchases in America is the lowest of all major countries. Where we devote around 16 percent of our income to food, people in Europe typically pay out 25 to 30 percent of their income. In some Communist countries that figure reaches almost 50 percent.

It is obvious that having food available cheaply and in abundance has freed countless economic resources for alternative use in providing for consumers' wants. My intention, Mr. Volcker and members of the committee, is to give agriculture its due recognition. For too long our Nation has taken agriculture for granted. We cannot afford to neglect our most important industry.

Last month, your associate, Frederick Schultz, vice chairman of the Federal Reserve, appeared before my JEC Agriculture and Transportation Subcommittee to share his perspective on the role the financial sector plays in the agriculture economy. With so many changes in financial instruments and other innovations to facilitate money and credit transactions, with deregulation of financial services around the corner, with changes in Government lending practices and with the prevailing uncertainty in the financial market place, I ask you, Chairman Volcker, to give your attention to farm issues that often escape public notice.

In closing, I would like to share two quotes which in my opinion describe well the importance of agriculture to our political and economic system:

"Our agriculture system is the most productive in the world and it exhibits one of the highest productivity growth rates of any sector of the U.S. economy. Agriculture output has increased nearly 70 percent since 1950, while total input use has increased by only 2 percent. This stellar performance has provided the consumers of this Nation with a low cost but readily available, high quality food supply * * *." (John R. Block, Secretary of Agriculture, before the House Committee on Agriculture, March 31, 1981.)

"* * * The greatest economic and political problem facing our Nation is the supply of food."(Leonid I. Brezhnev, in a speech before the Communist Party Central Committee as reported by the New York Times, November 17, 1981.)

OPENING STATEMENT OF SENATOR HAWKINS

Mr. Volcker, it is a pleasure to welcome you to the Joint Economic Committee at this critical time in our economic lives.

I am extremely concerned over the continuation of high interest rates. At a time when it is imperative to stimulate economic growth and to get everyone working, the high cost of capital is destroying the opportunity to do so.

We need a monetary policy that is focused on the long run and controls money growth so that, to quote the Federal Reserve Reform Act of 1977, it is: "Commensurate with the economy's long run potential to increase production." Therefore, an immediate concern I have is with the recent surge in the money supply which far exceeds growth targets. The result: Instead of the reasonably steady progress toward lower interest rates, the Federal funds rate is inching up from its early December 1981 low of some 12 percent.

Our experience in 1980 should serve as a clear warning of what happens when money growth accelerates too fast, and too far in advance of economic recovery. Had the firm, steady monetary policy—advocated now by President Reagan—been pursued in previous years, it is likely that the record high interest rates of December 1980 would not have occurred. And today's rate would also be lower.

The present course of monetary policy bears too close a resemblance to the erratic moves of the previous administration, and it carries a cost. Just ask small businessmen, farmers, realtors, builders, and manufacturers who are being pushed into bankruptcy because of high interest rates.

I am amazed that none of the current members of the Federal Reserve Board had significant operating experience prior to their appointment in any of the industries being crippled by high interest rates. An all-powerful Board with over-long tenure, with power to determine its own budget is too far removed from the financial realities of American business. As I understand it, 5 of the 7 members of the current Board were previously staff employees of the Federal Reserve System. This institutional inbreeding promotes the continuation of institutional ideas, not those of a new administration. It must be remodeled.

To that end, I have sponsored a bill, the "Federal Reserve Act Amendments of 1981" which proposes long overdue changes in the operation of the Federal Reserve Board. As a step in the direction of restoring confidence in the central banking system, this bill changes the qualifications and terms of office for the Board of Governors, broadens the representation, and takes immediate action to place the Federal Reserve System on a budget approved by Congress, for the first time in history.

Mr. Volcker, I would appreciate your suggestions as to how we can lower interest rates and make further progress on slowing inflation. In addition, I would like to hear your views on revamping the Board in the ways suggested. I look forward to your testimony.

OPENING STATEMENT OF SENATOR BENTSEN

Mr. Volcker, you are starting to resemble a pincushion. After reading and hearing what my colleagues in the Congress and some administration figures are saying, I think you need some of those bodyguards accompanying Cabinet Members everywhere now. I can't say I agree with everything said of you. But, I do want to add my voice to the growing chorus expressing great dismay with our Nation's monetary policy.

Presidents at least as far back as Truman have said the buck stops with them. Well, on monetary policy, it stops with you.

There is a widespread belief which I share that the Federal Reserve is largely responsible for the recession now afflicting our economy. I certainly share your commitment to squeezing out inflation. Yet, it is now clear that the Fed clamped down too much last year—especially in the 2nd and 3rd quarters when the money supply measured by M-1 actually declined slightly, according to your own latest figures released on January 15. For 1981, M-1 grew 2.2 percent—below 3.5-6 percent target range.

The result has been an interest rate recession—and a depression in our interest-sensitive industries. Housing starts in 1981 plunged to the lowest level in 35 years. Car sales were at a 20-year low. Bankruptcies up 42 percent.

I conducted two meetings in Texas just for small businessmen and women earlier this month. I had overflow crowds at each one—and they came to lambast high interest rates. Even with our strong energy base, the State of Texas is being hurt, and hurt a lot by the recession. You are cutting the heart out of our small businesses and the housing industry, and they, in many ways, are the heart of our Nation.

I have another complaint. After 6 months of no growth in the money supply, the spigot has been turned wide open since October. M-1 has grown over the past 3 months at a 12.6 percent annual rate. Now that is what I call a stop-go, erratic, and disastrous way to conduct monetary policy. It is kicking the legs from beneath the President's program and created such a ruckus on Wall Street—and Main Street—that investors are demanding enormous risk premiums. It is no wonder long-term interest and mortgage rates have stayed high—and that we are seeing headlines such as the one in Friday's Washington Post saying, "Pressures Increasing To Boost Prime Rate."

What I want from the Federal Reserve is a predictable, stable, and moderately expansionary monetary policy in 1982—one which will continue progress toward price stability while allowing interest rates to subside. Until we see such a policy from the Fed and the lower interest rates that will follow as risk premiums decline, I can hold out little promise for a recovery this year.

Representative REUSS. Mr. Volcker, we have your prepared statement, please proceed.

Mr. VOLCKER. Perhaps I could proceed by reading my statement. I'm sure we will get to answering these detailed questions as the session proceeds.

Representative REUSS. That will be great.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I appreciate the opportunity to appear before you today at the start of a new congressional session. We will be facing critical decisions on economic policy in the weeks and months ahead. Toward the middle of next month I will be reporting to the appropriate committees on monetary policy in more detail, and this morning will confine my statement to more general considerations.

Over the past 2 years, we have faced up squarely to the necessity of reining in the inflation that had come to grip the economy over a long period of time. There are now clear signs of tangible and potentially sustainable progress toward that objective. But the economy is also caught up in the recession, following several years of unsatisfactory performance. In a real sense, the Nation is paying the costs of the distortions and imbalances in our economy, created in large part by the years of inflationary experience.

In approaching these problems, and in considering monetary, fiscal, and other policies, it seems crucially important that we keep firmly in mind the lesson of the 1970's—sustainable growth cannot be built on inflationary policies. Most positively stated, the progress we are clearly beginning to see on the inflation front, carried forward, will help lay the base for recovery and much better economic performance over a long period of time.

As you know, the economy, after a burst of growth early in 1981, leveled off, and in recent months strong recessionary forces took hold. Real consumption expenditures have declined, in part reflecting an increased savings rate. A sustained higher rate of savings would, of course, be healthy in a longer term perspective, and a number of policy measures have been adopted to strengthen savings incentives. But in the short run, declines in consumption have led to unwanted inventories, sharp reductions in production, and postponement of some capital spending.

These are elements of a classic recession pattern, and at this point, the decline in economic activity has been of proportions comparable to other post-World War II downturns. What is different and so distressing is that the recession has been superimposed on a pattern of sluggishness extending over some years; unemployment was high to begin with, and now, at 8.9 percent, stands very close to its postwar peak. Moreover, we have been left with a legacy of extraordinarily high interest rates and financial pressures, conditions fundamentally associated with the years of inflationary behavior and expectations.

The upward trend in unemployment in recent years and the early onset of a new recession reflect both the difficulty of living with inflation—and of bringing it to an end. Unsatisfactory economic performance, well below our reasonable potential, has extended over a number of years. The origins can be traced back at least as far as the mid-1960's, when, as a nation, we failed to accept the budgetary consequences of spending for a war and vastly expanded social programs at the same time.

Once fairly started, the inflationary process assumed a momentum of its own, with only short interruptions in earlier recessions. At intervals, the massive oil shocks, and to a lesser extent worldwide crop shortages, ratcheted up the inflation rate, affected the real income of most workers, and led to the need for large adjustments in our industrial structure, depressing some traditional industries while spurring others.

Through this period, one aspect of our economic problem became increasingly obvious. Inflation came to be viewed as a permanent part of the economic landscape, and workers and businessmen, savers and investors, borrowers and lenders built expectations of continued inflation into their daily economic decisions.

There have been profound effects on financial markets and interest rates, inhibiting growth and investment. Higher effective tax rates became a drag on the economy and the interaction of inflation with the tax system tended to reduce business profitability and divert both business and personal planning away from productive effort and innovation into more speculative or purely financial areas.

It's worth recalling the culmination of the process in late 1979 and early 1980 when concern about inflation and budgetary outlook brought interest rates to sharply higher levels and incited a speculative outbreak in commodity and precious metals prices, even as prices of long-term securities fell sharply. There was broad recognition that inflation was eroding the foundations of our economy and that strong action had to be taken to restore stability.

In the circumstances existing that job fell largely to the Federal Reserve and monetary policy. As you know, we have been pursuing a policy of reducing the pace of monetary expansion over a period of time to rates consistent with price stability. But monetary restraint, however necessary, can be a blunt instrument. That is particularly true when prolonged experience with inflation builds in expectations that it will continue, when inflationary momentum is built into the cost and pricing behavior, and when productivity improvements are low.

For all its difficulty, monetary restraint must be an essential part of any successful effort to damp inflation. Strong upward price pressures may arise from a variety of sources not directly related to monetary conditions—the oil-price shocks are a leading example. But those impulses will persist and spread only if they are accommodated by growth in money. And, as we have learned, we cannot really accommodate to inflation without damaging economic growth and productivity.

Now, we can see highly encouraging signs that the inflationary tide is turning—we see it in the data and, less tangibly, in expectations. The improvement, to be sure, has been associated with highly unsatisfactory business conditions. Prices of commodities in particular are sensitive to depressed demand, there are incentives to reduce inventories and the weakened financial position of many companies has led to extraordinary efforts to restrain wages and costs generally.

No successful program to restore price stability can rest on persistent high unemployment and depressed profitability any more than we can build prosperity on inflation. The obvious challenge is to shape our policies in a way that can permit and encourage recovery to proceed while maintaining the progress we are seeing toward greater price stability. Some of the groundwork has already been laid or is in process. Price expectations have calmed and there is some evidence that the underlying trend of costs is slowing.

Our current inflation did not originate as a "wage-push" phenomenon. But in an economy like ours, with wages and salaries accounting for two-thirds of all costs, sustaining that progress will need to be reflected in moderation in the growth in nominal wages. The general indexes of worker compensation still show relatively little improvement, and prices of many services with a high labor content continue to show high rates of increase. But we are all aware of recent negotiations completed or in progress that seem to point toward some significant moderation.

In many of these instances, to be sure, the changes reflect the most intense competitive pressures, and the potential benefits in terms of retaining jobs is clear. Major tests of the changing climate still lie ahead; 1982 is a particularly important bargaining year. It seems to me crucially important, not least for the workers directly involved and for those now unemployed, that this emerging pattern of greater moderation be extended. The end result of moderating nominal wages should be higher real wages for workers generally, for it can speed and sustain the process of recovery.

The prospect for greater price stability, at least in the near term, is reinforced by the outlook for stability in petroleum prices and ample crops. And looking further ahead, partly as a result of the more favorable tax climate, we should be able to achieve renewed and sustained growth in productivity as the economy grows.

Obviously, it is far too soon to claim victory in the fight on inflation. To make that prospect a reality, properly restrained and cautious monetary policy will continue to be required. And at the same time, we need to combine that antiinflation effort with policies that will encourage and sustain the recovery process. The linkage lies in considerable part in encouraging favorable developments in financial markets and interest rates, and there are critical implications for the mix of governmental policies.

An adequate balance in policies can add to financial stress, with severe consequences for vulnerable credit-dependent sectors of the economy—consequences most dramatically reflected in homebuilding and the problems of many small businessmen and farmers.

Moreover, our need to improve and modernize our plant and equipment is evident. That need lay behind many of the tax changes enacted last year; but overburdening monetary policy in dealing with inflation, with consequences for financial pressures in the marketplace, can work against that very objective.

This year we will have a very large Federal deficit. To the extent that deficit is a passive reflection of recession—which in turn reduces other credit demands—even that deficit can be manageable without, in itself, standing in the way of a more favorable financing climate.

The large Federal contribution to the income stream—including the second stage of the tax cut at midyear—should help buoy economic activity. But during a period of recovery, deficits approaching the current magnitude would have quite another implication; in an environment of limited monetary expansion and rising private demands for credit, they would threaten prolonged strain and congestion in financial markets, with strongly adverse consequences for other borrowers. And those consequences are not merely a hypothetical possiblity for the future. It is that concern that preoccupies the thinking of many potential investors in the market today, making them reluctant to commit funds for any long period of time, fearful that interest rates may not decline or could even rise.

You and I may think those concerns overdone, particularly in the light of the extraordinarily high level of interest rates today in relation to the prospects for inflation. But the lesson for policy seems to be unambiguous. Fiscal action needs to be directed toward the progressive and substantial reduction of the deficit as recovery proceeds.

We know there is a deep-seated public instinct associating large deficits with inflation, and a great deal of history pointing in that direction. We could also engage in abstract debate about whether budgetary deficits are necessarily inherently inflationary, and the point would be advanced that, given sufficiently severe monetary policy, they might not be. But that would imply far higher interest rates, lower investment, and poorer economic performance generally.

Paradoxical as it may seem, action by the administration and the Congress to bring spending and our revenue potential into closer balance—and ultimately into balance and surplus—as the economy expands can be a major element, through its implications for credit markets, in promoting recovery and nurturing it. Credibility in the budget, through its effects on expectations and behavior, could only work toward lower interest rates and speeding the disinflationary process.

In essence, the burden of my comments is that the need for disciplined financial policies to carry through the anti-inflation effort is not lessened by the current recession. It's not just a matter of the longer run—to back away from the commitment to deal with inflation would be a disturbing matter for financial markets today, complicating the prospects for early recovery.

Interest rates fell appreciably last fall, and most have remained substantially below earlier peaks. But in both real and nominal terms, they remain extraordinarily high. The fact is markets remain sensitive, disturbed, and uncertain despite the encouraging trend toward less inflation. We cannot wish these doubts and skepticism about the future away; we can act to dispel them by our actions.

That, of course, has important implications for monetary policy. As I indicated at the outset, I will deal more specifically with our intentions with respect to monetary growth after the Federal Open Market Committee, in the normal course, meets next week to adopt guidelines for the coming year. The basic thrust of policy will remain one of encouraging continued progress on the inflation front. With such progress, there should be adequate financial resources to support renewed economic growth.

Present economic conditions are those of pain and hardship for many. In working to relieve them, let us not forget the basic circumstances that brought on the difficulty. Let us take heart from the signs of progress in turning the corner toward greater price stability. We can build on that progress, and, in so doing, restore the confidence and financial conditions so critical to recovery.

Representative REUSS. Thank you, Chairman Volcker. We shall now inquire under the 5-minute rule.

You have heard my stated belief that it's a mistake for the Federal Reserve, in the teeth of the severe unemployment and recession, to reduce this month its target for the most common aggregate, M_1, from its 1981 3.5 percent to 6.0 percent level to a 2.5 percent to 5.5 percent level.

May I have your assurance that at the Open Market Committee next Tuesday my views that the 1981 targets ought to be retained will be considered?

Mr. VOLCKER. Yes, sir, I will report your views, and I'm sure we will review all the considerations.

If I can just make a couple of comments as a matter of background and amplification of your own comments, Mr. Chairman. A target for next year could be compared with last year's target for M_1. As you noted, last year we came in on the low side of that target for M_1; in that sense, the target you cited for next year would not necessarily imply a lower rate of growth for next year than what we have actually experienced in 1981.

Representative REUSS. No; but my fear is that the markets, seeing that you want that added leeway on the extremely low side, will think that you want it for some good reason like the fact that you intend to use it, and that it will continue to scare the hell out of the markets.

Mr. VOLCKER. We have left ourselves, at least symbolically, a little more room next year in terms of the target partly because of concern over the implication of some technological changes going on in the markets that may artificially depress M_1 growth. We could conceivably go in the other direction of increasing M_1 growth. We are in the midst of developments that make these figures, more than unusually hard to judge.

Let me also mention that M_1 is not our only target. When you look at the performance of the other aggregates last year, you do not get that same sense of a slowed rate of growth as you do from M_1. M_2 growth, in particular, was not much different last year from what it was the year before, and it was on the high side of our target range, so it depends upon which aggregate you look at.

Representative REUSS. I'm glad to hear that the matter will be considered and I ask particularly that a record vote be maintained so that we may know who voted how on this important question.

Turning now to another worrisome matter, there's been much comment about the fact that there's been an upward surge in M_1 in the last few weeks, some 13-plus percent since November, and you have pronounced yourself at a loss to account for that. Let me suggest something to you which may be an explanation.

Could it not be that that unseemly upward blip in M_1 has the following cause: On the supply of money side, the Fed has been keeping the money supply austere. That is your goal and you have carried it out. On the demand side, however, some things have been happening which are the direct result of Reagan economics. They are three in number: First, as a result of the horrendous deficits at the Federal level, both actual and prospective, the Treasury is in a heavy borrowing position and that increases the demand for money; second, as a result of the merciless cuts in the level of grants to State and local governments, those poor souls have had to go into the market to borrow money to pay the help on Saturday night in very large amounts. That is a second Reagan cause swelling on the demand side; third, business is in deep distress throughout the country with record bankruptcies, terrible stringencies in finding the money to pay employees and to carry inventories, and business borrowing is high.

Therefore, isn't a perfectly plausible explanation to this mystery the fact that demand caused by the Thatcher-like elements of Reagan economics has been speeding the money supply upward, just as it did with poor Governor Richardson of the Bank of England when he started following Margaret Thatcher's advice? How about that?

Mr. VOLCKER. I think you're quite right that there's a demand side to the money supply as well as a supply side. I wouldn't want to be characterized as at a complete loss in understanding what's going on here. The fact is, it is unusual to have this kind of an increase in the money supply when production and incomes are as weak as they have been recently.

In evaluating this, looking at the period of November and December let's say, I would not find that particularly disturbing or unusual, although I wouldn't want to see the rate of increase at that speed prolonged. Following a period of slow growth, the numbers were reasonable in terms of our own short-term objectives; they were high, but not outside the usual range of difference in the short-term objective.

The more surprising element was the big jump up in the early part of January. In analyzing this more closely—and that analysis will of course have to continue—I think there may well be an element of exceptional "window dressing," if I may use that term, around the end of the year. The money supply has been well depleted in recent years relative to the level of economic activity, and it appears there may be some effort to build up bank balances through the corporate world over the New Year's period that may be washing itself out.

There is another element which arises, I think, on the demand side. The increase beginning in November and running through December and into January has been exceptionally heavy, concentrated in NOW accounts, which of course is a new instrument this year. It's been accompanied by an increase in savings deposits—another highly liquid and quite comparable financial instrument in some respects—while there are some signs that other types of individual investment may have slowed a bit during this period. So, there are at least some tentative indications of a desire for highly liquid asset holdings on the part of the general public, reflected in NOW account growth and in savings deposit growth which is not in M_1 but, as I say, is a similar instrument.

In any event, quite obviously we would not like to see this rate of increase in M_1 continue, but it is quite possible that some temporary factors are at work here.

Representative **Reuss**. Senator Mattingly.

Senator **Mattingly**. Thank you, Mr. Chairman.

Mr. Volcker, I was slightly shocked by the newspaper reports that the surge in the money supply took the Fed by surprise. Such an increase in the money supply in the recent weeks has really reignited concern about the future of the financial markets and not only that, but interest mortgage rates climbing once again. It's my understanding that in 1979 the Fed established a policy to control the quantity of money growth by setting growth targets. While I agree that a consistent rate of growth is necessary, it seems to me that the Fed's actions—in other words, a 3-month money supply growth of 12 percent, a 3-month supply growth of 2 percent and so forth—is an incorrect and undesirable way to achieve a 6-percent annual growth rate in the money supply.

In other words, it would appear that Volckerism has become synonymous with erratic and inconsistent money-supply growth and what we need is a consistent growth rate in the money supply and one which eliminates the blips as we have recently experienced.

I think some of your critics contend that to achieve a consistent and accurate monetary growth the Fed must shift to a contemporaneous requirement. How can the Fed more accurately achieve a consistent growth pattern in the money supply and would you comment on the criticism and indicate any change of policies the Fed is contemplating?

Mr. **Volcker**. I would be glad to, but first I'd like to put some of these numbers in a little different perspective.

You have emphasized some of these short-run ups and downs which——

Senator **Mattingly**. It was just an example.

Mr. **Volcker**. I don't think they're entirely avoidable and, whether it's possible to avoid them or not. I'm not sure it's always desirable because of influences that come from the demand side. To put it in perspective, I might recite the annual figures for the money supply in recent years since we adopted the approach that you mentioned. We had a 7.8-percent increase for the whole year 1979, which declined to 6.0 percent last year, and, using a shift-adjusted figure, to 4.6 percent in 1981. I think that reflects the kind of general decline that we have been looking for over a period of time. It is that sweep of developments, that movement downward, which is far more important in terms of inflation in the economy than short-term ups and downs.

To come to your point on contemporaneous reserve accounting, that is a modification of the technique that's used, as you pointed out. It was used some 10 years ago or more and for a considerable period of time before that. We have been considering returning to that kind of system in a modified form and have a proposal in that direction out for comment.

Having said that, I do not think that technique itself would necessarily produce any radical change in the movement of these figures over a short period of time. The short-term fluctuations, in my opinion, arise largely out of short-term fluctuations in the demand for money, and sometimes in the supply side too. You have to look at both sides. Look at what we are doing in terms of supply, and if you can't explain it in the short run on the supply side, in terms of the provision of reserves and the other indicators to which you referred, then the demand side will cause this fluctuation.

Senator **Mattingly**. But it would cause a reaction time, wouldn't it?

Mr. **Volcker**. It should, theoretically, all things equal, give you the opportunity to react a couple of weeks earlier.

Senator **Mattingly**. Which is rather important at this point.

Mr. **Volcker**. That's the question, How crucially important is that, offsetting it against some of the other disadvantages?

Let me explain a different aspect of it. If you want to control money extremely tight in the short run on the supply side, it's really an issue of doing something about that area in the supply of reserves that in the short run depends on the initiative of the banks, that is, doing something about the discount window. If you think of the extreme—of, let's say, closing the discount window, of not providing that option to the banks, which is conceptually possible—the serious question in my mind is, How much more erratic behavior would that produce in interest rates in the short run if banks do not have that safety valve for meeting a reserve need in a particular week or particular 2- or 3-week period?

Senator **MATTINGLY**. The fact of the matter still remains that all the markets are subject and react negatively to the inconsistencies and I think, returning to consistency, I think the consideration of contemporaneous requirement is good and I'm glad that you've agreed to reconsider it.

Mr. **VOLCKER**. We are obviously considering this. We wouldn't put it out for comment if we didn't think there was a lot to be said for that approach, but I would not think of it as producing an absolutely steady money supply from month to month; I don't think we're ever going to achieve that. Rather, looking at it in a strictly analytical sense, it's a question of whether that approach would produce more stability in the money market; the indication is the opposite.

Senator **MATTINGLY**. I see my time is up. Thank you.

Representative **REUSS**. Thank you. Representative Richmond.

Representative **RICHMOND**. Thank you, Mr. Chairman.

Good morning, Mr. Volcker. I have just two fairly practical comments on your statement. You indicated that we have set the stage for massive improvements in our industrial household, as it were. On the other hand, we just read a statement the other day that machine toolings were down 49 percent for the month of December and down over 30 percent for last year.

Now here we have had radical new tax legislation, certainly among the most radical tax legislation since Wilbur Mills was here; right?

Mr. **VOLCKER**. Right.

Representative **RICHMOND**. Everything was beamed to helping industry retool.

Mr. **VOLCKER**. Right.

Representative **RICHMOND**. How can you account for the fact that even though we did everything possible to get industry to retool they have done exactly the opposite; they have done 30 percent less this year than last year? In addition, we all know the basic problem with the United States today is the fact that our industry is not adequate and we are not competitive in the world.

Mr. **VOLCKER**. I think we have two or three things running against the thrust of the tax measures in the short run. I couldn't say the tax measures don't move in the direction you indicate over a period of time. Right at the moment we are in a recession and you normally get cutbacks in that kind of activity in the midst of recession. Underlying and accompanying that process have been these extraordinary pressures on financial markets which in the immediate sense clearly don't run in the same direction as stimulating plant equipment or other forms of economic activity. That is our crucial problem, it seems to me, in getting recovery going and sustaining it.

Representative **RICHMOND**. How would you compare this to the Japanese system when you know the Japanese Government runs a deficit larger than ours yet the workers themselves pay for that deficit through their postal savings bonds which receive less than 6 percent interest? I think our whole problem in the United States—you say the savings has increased, but what's actually increased is money market savings. It's hard to consider money market savings as savings when you can pull the money in and out on any given day and write checks on it. It's not the old type of savings that you and I are accustomed to when people put a certain amount in a savings account every year. That's what keeps the Japanese system going. The Japanese worker puts half of his money in a postal savings bond which helps his Government support its national health insurance and national railroads and everything else, and the other half goes into his savings account at the company which goes into the company bank and, in turn, that money goes right into the factory.

Until we get real savings in this country—and as you know, a lot of the Japanese savings are tax free—I think we really ought to look at the Japanese example. It's working. It's actually happening to them. They have no unemployment. Next year they will produce more industrial goods than we will. Can you imagine? Next year, with half the population and a piece of property the size of Montana, their industrial output next year will be larger than that of the United States. So they must be doing something right. It seems to me we ought to look and see what they are doing right.

Mr. VOLCKER. They are obviously doing a great many things right. I referred to the size of savings increasing. We don't know yet whether that's a permanent increase but——

Representative RICHMOND. What type of savings?

Mr. VOLCKER. Savings rates have moved away from the very low levels that we had for a while; let's hope that's a sign of a more permanent change. Savings is income minus consumption, but I think you're quite right that a large proportion of this figure is going into highly liquid forms at the moment. The real problem, from the industrial standpoint, is getting some of that savings into longer term forms at reasonable interest rates.

It may be that we can see some sign of progress here. At least that money is not going into speculative outlets as much as it was a year or two ago. It's not going into commodities, gold, collectibles, art, in the same way it was a couple of years ago. But it's certainly true that an extreme degree of caution is still being reflected in the markets, where people tend to want to keep their assets highly liquid.

Representative RICHMOND. Certainly anything in the money market can't be used for long-term investment. It can't be used to rebuild our steel industry or many of our other basic industries.

Mr. VOLCKER. These funds are used for investment, including long-term investment to some extent, but not with the same solidity as a base as one would like to see if the long-term markets were in better shape.

Representative RICHMOND. Thank you, Mr. Chairman.

Representative REUSS. Thank you, Mr. Richmond. Representative Wylie.

Representative WYLIE. Thank you very much, Mr. Chairman.

May I say, Chairman Volcker, I do not happen to be one of those persons who tries to blame all of our economic ills and problems on the Fed. I think that perhaps our tax cut last year was too big and too soon and has maybe contributed to our big deficit. But the budget deficit is now expected to be somewhere in the neighborhood of $80 to $100 billion and not what was originally projected. You say in your statement that you know there is a deep-seated public instinct associating large deficits with inflation, and I happen to agree with that. You also indicated in your statement that there has to be a progressive lowering of the size of the federal deficit.

Do you agree then with the observation that I've made that there does have to be a closing of the gap as far as the deficit is concerned if we are to reduce the unemployment rate? Would you comment on that?

Mr. VOLCKER. I think we are in a situation in which some of the traditional economic thinking has to be turned a little bit on its head. I'm not so concerned about the deficit this year, given the degree to which that is influenced by lower incomes and by recession, but I am very concerned about the deficit in the outyears, because we do obviously want to look forward to recovery and growth in those years, and recovery and growth means more private credit demand. Increase in mortgages outstanding is rather small now because housing is so depressed, but if housing is going to recover, we will need a lot more room so that some of those savings can go into mortgage investment.

If the Government is going to stand out there and preempt a very large share of the savings flow, that calls into question what financial market conditions will look like out there in 1983 and 1984. Not only does that present that problem of 1983 and 1984, but also anticipation of the future situation tend to block the markets today.

The more reassurance we can provide about the fiscal position in the so-called outyears, the better off we're going to be for full recovery and expansion in the near term, because anticipations do work back to influence present financial market conditions.

Representative WYLIE. Yes, I agree. In your estimates have you given a figure as to what you expect the Federal deficits to be in, say, fiscal years 1982, 1983 and 1984?

Mr. VOLCKER. In fiscal year 1982, the current fiscal year, you're getting in the neighborhood of a $100 billion deficit. I think that is, as you suggested, a rather common view. What it is in those outyears depends upon what you and the administration do in the next 6 months.

I think we do face a budgetary situation—and this is the hard fact of the matter—in which, left alone, without action on the expenditure or the revenue side, the deficits would tend to get bigger rather than smaller, even as recovery proceeded. That is the nature of the fiscal problem at the moment, and it's that prospect which helps cloud the picture of how great the recovery will be for the reasons I suggested. I think it is critically important that you take advantage of this opportunity that you have—there's not much you're going to do or maybe should do about the current deficit—to look out into the following years; you do have a critical problem.

Representative WYLIE. Have you been able to quantify in your own thinking what the deficits would be for the outyears in fiscal 1982, 1983 and 1984?

Mr. VOLCKER. What the deficit actually turns out to be, as you well know, depends upon what, in fact, happens to the economy. There's a big influence on the revenue side and some influence on the expenditure side from the level of economic activity. Frankly, what I would like to see and make allowance for, is a budgetary posture that is close to being in balance when the economy is operating at a satisfactory level. What's the definition of an economy operating at a satisfactory level? It seems to me that looking at relatively recent history of the past 4 or 5 years or more that would translate into an unemployment rate, let's say, in the neighborhood of 6 percent, which is as low as we have had it in recent years. If we could achieve a budgetary posture that was consistent with balance in that kind of economic circumstances, I think fiscal policy would have made all the contribution it could reasonably have made. That's not the case at present. Of course, we are not going to have 6 percent unemployment for a while, so that thinking doesn't say balance the budget in 1983 or even 1984, but it says move in that direction with the economy expanding.

Representative **Wylie**. Thank you. I have been given a note that my time has expired. I'm going to stick around however.

Representative **Reuss**. Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman.

Chairman Volcker, on Thursday of last week the Federal Reserve told us the auto industry was for the first time in a long time operating at below 50 percent capacity. The homebuilding industry, as we know, is probably operating below 50 percent of capacity too, and the housing starts last year were a bare million compared to over 2 million 2 years ago, and these two industries account for probably 3 million of our present level of unemployment, maybe more than that.

The economy is, as a whole, operating at 73 percent of capacity—very, very low by any historic measure.

As you know, unemployment is at nearly 9 percent, 8.9 percent.

My question is that with interest rates now rising and the Federal Reserve fiscal release which was just out today I guess, or the last couple days, indicates that it's going up steadily every week since December, and at this low level of capacity and unemployment it's hard to see at this point how continued limited credit contributes further to reducing inflationary pressure. How does it? How does that work? How is that going to hold down prices in the automobile industry, the homebuilding industry and other industries if we continue to pursue the present policy?

Mr. **Volcker**. What is important, I think, in terms of the present financial environment and the interest rate picture to which you refer, is that we do not conduct policies on the monetary side or on other public policy fronts that presage or indicate a retreat on the inflationary front. You will then not have, no matter how much money we put into the market, the confident lending in the market that's conducive to the kind of interest rate picture that's desirable in the industries that you referred to and in others. If I can overstate your remark just for the purposes of making a point, if we said, "OK, the supply of credit is going to be unlimited and we're going to pump money into the economy without limit because we're in a recession in the short run," the result would be perverse in terms of actual conditions in the credit markets.

Senator **Proxmire**. I understand that, but you see what I'm driving at—with interest rates rising we could possibly have autombile capacity drop below 40 percent, homebuilding drop below 40 percent—that's not impossible and you acknowledge that's a real possibility—and I think a probability. Unemployment going up to 10 or 11 percent.

My question is, Where do we recognize that the economic consequence of these bellwether industries is not really contributing to getting inflation under control? Obviously, we could increase production in automobiles, homebuilding, and these other areas and, as a matter of fact, costs would decline and productivity would increase.

Mr. VOLCKER. Productivity would increase.

Senator PROXMIRE. And you would have a healthier economic situation with a prospect of perhaps a lesser inflationary pressure. Isn't that right?

Mr. VOLCKER. I don't think you could say that without knowing a little more than your question implies. I certainly think we want to get into a situation—I hope and I believe we are getting into a situation—where we can see expansion in those industries and others consistent with a decline in the inflation rate, consistent with declines in interest rates. I hope and believe that that process, once started, can extend over a long period of years.

The question is, How do we get from here to there?

Senator PROXMIRE. That's right.

Mr. VOLCKER. I don't think we're going to get from here to there if, as part of that transition, we give the impression that the opposite is going to happen, that the increase in money and credit that we permit is going to be swallowed up in an increasing inflation and that interest rates are going to reflect the anticipation of increasing inflation. We must get into a position where we can get increases in production in those industries consistent with further progress on inflation. That does not lead to the conclusion that we can go at it simply by indefinitely expanding the supply of money and credit; I think that would be counterproductive.

Senator PROXMIRE. I understood you to say that you're not so concerned about deficits this year.

Mr. VOLCKER. That's right.

Senator PROXMIRE. It's the deficits that are creating anxiety and fear in the financial markets and contributing to high interest rates and likely to prolong the recession. I would think you would be deeply concerned with the deficits this year as well as in the out-years. I understand the out-years and I understand we can't do a hell of a lot about it this year, but isn't this a very serious problem?

Mr. VOLCKER. Certainly it is in the sense that if we didn't have such a big deficit this year and didn't have a pattern of large and even rising deficits over recent years, we would have more favorable financial conditions for the private sector right now. But, given all that has happened, given the fact that we are in recession, I would concentrate my fire, so to speak, on the out-year deficits rather than on this year. Of course, it's too late to do anything very major about this year anyway. I think you can get the favorable effects on expectations in the financial markets by looking at the out-years, and this will be manageable against that prospect.

I think your concentration belongs on the out-years. I don't mean to suggest that we would not be better off in many ways if we hadn't had a deficit approaching $60 billion last year—or $80 billion when we include the off-budget programs—that that did not have a lot to do with the congestion we saw in financial markets in 1981 which helped to precipitate the recession.

Senator **Proxmire**. My time is up. Thank you.

Representative **Reuss**. Representative Rousselot.

Representative **Rousselot**. Thank you, Mr. Chairman.

It's nice to be back, Mr. Volcker, and see the man that so many people in my district talk about all the time.

Mr. **Volcker**. In a complimentary way, of course.

Representative **Rousselot**. Of course. Do you plan to raise the discount rate?

Mr. **Volcker**. I don't usually use a forum of this sort——

Representative **Rousselot**. That's why I thought I'd ask it.

Mr. **Volcker** [continuing]. To give an indication on that score, but we have not done so and it's not on my immediate agenda.

Representative **Rousselot**. I'm delighted to hear that. How long do you think that will last?

Mr. **Volcker**. I would not comment beyond that.

Representative **Rousselot**. Now as you know, some have argued that what the Fed did last year was very much in line with the President's supply side program. Many of us do not quite agree with that because we understood the President to be hoping that there would be a gradual and consistent reduction in the growth rate of the money supply and that it was never contemplated on his part that it would be quite as much of a rollercoaster as it turned out to be. As you know, the annual rate percentage of increase for M_1 was over 20 percent since November or has been. What do you plan to do to try to remove the volatility of the growth rate of money supply?

Mr. **Volcker**. First of all, I don't think it was exceptionally volatile last year. Let me give you the——

Representative **Rousselot**. Zero growth for 6 months.

Mr. **Volcker**. You can pick out the high points and the low points for particular weeks and get all sorts of interesting calculations.

Representative **Rousselot**. Well, for 6 months it was zero.

Mr. **Volcker**. Using the calendar quarters, it was 2.1 percent, 1.1 percent, 1.9 percnet, and then, in the last quarter, where we were trying to have a bigger growth, it was 8 percent. I think the Open Market Committee minutes said we were aiming for 7 and we hit 8 for the fourth quarter. I'm not happy about all these intervening ups and downs, but, as I indicated earlier, I'm not sure you could or would ideally even want to iron all of those out, because some of those arise on the demand side and would give rise to even more instability in interest rates. I like instability in interest rates even less than I like this short-term volatility in the money supply. When we have these large increases, our normal operating technique does not voluntarily supply the reserves to support them; we're not doing so now; we did not do so earlier. When the money supply tends to be low, we tend to provide reserves in a fashion that tends to increase the money supply. That process works, obviously not with precision in the short run, but it has worked.

Representative **Rousselot**. Well, as you know, according to the way I read the figures, the money supply was zero growth for almost 6 months, then we jumped at an annual rate of 1 month from 13 to 20 percent. Isn't that volatility at its best?

Mr. **Volcker**. I will accept your number. I don't have it right in front of me. Let's say it was 6 months of no growth, from the very peak in April.

Representative **Rousselot**. I'm just reading your own report.

Mr. **Volcker**. That peak in April was a kind of abnormal peak; if you go from the abnormal peak to the lowest point, you find thereafter that you get a period of no growth. The quarterly figures that I recited to you show a pattern—they don't just pick out the absolute peak week and go to the absolute low week—a trend over time which is reasonably orderly.

Representative **Rousselot**. Well, I still want to come back to the fact that for 6 months you had almost zero growth and that followed a period where you had a 10.8 percent money growth in the previous 12 months and the previous 12 months to that you had a 13 percent increase. Doesn't that signal the wrong things to the marketplace?

Mr. **Volcker**. What the market should be looking and what the market does look at to a considerable extent is what the trend is over time, and I think the trend over time has been unambiguously toward a somewhat slower growth rate, which is what we were trying to achieve.

Representative **Rousselot**. Well, Mr. Chairman, my time has expired. I'm not sure I got a full explanation.

Representative **Reuss**. Thank you. Senator Kennedy.

Senator **Kennedy**. Thank you very much, Mr. Chairman, and I, too, want to join in welcoming Mr. Volcker to the committee here this morning.

Mr. Volcker, many of us on this committee have profound disagreements with the administration's economic policy. The administration promised us growth, but they have given us a recession. They promised us jobs, but they have given us the worst unemployment since the Great Depression. They promised to balance the Federal budget, but they have given us the biggest budget deficits in our history. And they promised to end waste, but they are making a wasteland of the economy.

One of the fundamental questions we face in the Congress is how to secure coordination between fiscal and monetary policy in order to achieve a balanced economic policy capable of returning the country to long-term economic growth, prosperity, and price stability. The Nation is careening toward economic disaster if we keep going under the present schizophrenic policy, with the administration pressing hard on the accelerator of fiscal policy and the Federal Reserve pushing just as hard on the brakes of monetary policy.

Now is the Fed's monetary policy also the administration's monetary policy? We understand the independence of the Federal Reserve, but have you ever asked the President what he wants in terms of monetary policy?

Mr. VOLCKER. The monetary policy is the Federal Reserve's policy and I would accept, as one Board member anyway, the responsibility for it. But I think it's also fair to say, that restraint on monetary growth and pulling down these figures over time is consistent with the administration's view of monetary policy as best I understand it.

Senator KENNEDY. But have you talked with the President? Has he requested any communication with you? Have you had direct contact with him?

Mr. VOLCKER. I have direct contact with him from time to time.

Senator KENNEDY. And you have talked over monetary policy with the President?

Mr. VOLCKER. We have touched upon that from time to time.

Senator KENNEDY. And is it safe to say that your monetary policy at the Fed is consistent with the administration's view about where monetary policy ought to be?

Mr. VOLCKER. Again, in broad terms of movement over time toward reduced rates of monetary and credit growth, yes. I have read comments occasionally, as I'm sure you have, that at a particular time it's either too low or too high, but in terms of the general trend of things I'm not aware of any real difference.

Senator KENNEDY. I wonder where that meeting with the President took place, whether it was in the Oval Office of the White House or in the woodshed. I'm trying to get some idea of how the administration views the policy of the Fed. But I'm also interested in how you view their policy. Can you give us your assessment of the Reagan administration's supply-side economics—can it work or is it just too inflationary? Obviously, we are concerned about the lack of coordination between fiscal and monetary policy, and we would be interested in your assessment of their fiscal policy.

Mr. VOLCKER. There are a number of elements in that policy, as you know. Great stress has been laid upon the potential benefits of a reduction in tax rates and in marginal tax rates in terms of direct income taxation in particular. Looking at that segment of policy alone, I agree that works in the direction of and is desirable and helpful in terms of potential investment, potential productivity in the economy.

What I have consistently emphasized is there's more than one side of the budget and that policies have to be worked out in the context of a budgetary position that doesn't put undue stress on the financial markets, because otherwise I think you work against the very objective that is sought. I have had considerable concern about the net budgetary outcome.

Senator KENNEDY. I think you made reference to that concern in your prepared statement. But given the fact that you believe there has to be at least some stimulus in terms of tax cuts, do you think the size of the stimulus in overall fiscal policy is too expansionary?

Mr. VOLCKER. I have concerns about it as it sits at the moment.

Senator KENNEDY. What are the concerns? Is it too large?

Mr. VOLCKER. My concern is that the deficit would be too large and there would be too large an imbalance between revenues and expenditures; of course, you have an opportunity to move toward correcting that in the coming months.

Senator KENNEDY. Well, my time has expired.

Representative **Reuss**. You may continue.

Senator **Kennedy**. Just to follow this, we have a higher expansionary tax policy of some $750 billion in tax cuts over the next 5 years. Do you think that figure should have been less, should have been closer to $500 billion, should have been closer to $400 billion, or $300 billion, or are you satisfied with the $750 billion?

Mr. **Volcker**. There are two sides of the budget. That was a very large tax cut and it implied, in my mind that there would have to be some follow-on, with other actions to reduce the——

Senator **Kennedy**. The debate was whether it was going to be $38 or $40 billion of reductions in expenditures. That's been generally understood. So we're talking about $200 billion in spending cuts in five years, and $750 billion in tax cuts. That's a huge imbalance.

Mr. **Volcker**. As I said, the debate was on reductions in the range you suggest, but there were, in the administration's program at that time, some rather large numbers labeled as "savings yet to be achieved" or "proposals not yet enacted for 1983 and 1984." That is where I think the crucial period is, and that still stands out as an uncompleted part of the job.

Senator **Kennedy**. Thank you.

Representative **Reuss**. Thank you. Senator Abdnor.

Senator **Abdnor**. Thank you, Mr. Chairman. I'm sorry I was late today. I did have an opening statement.

Representative **Reuss**. It will be included in the printed record.

Senator **Abdnor**. Mr. Volcker, I too welcome you to this session today. I've heard a number of problems, particularly in various businesses and professions of this country, and I guess one of my major overall concerns, coming from where I do, is the business of agriculture. It's certainly in the doldrums. It's not something that happened last year. It's been in the making for quite a while.

I'm concerned that there isn't more concern shown by our economists in the business world over the situation agriculture finds itself in today. It certainly has its problems when it comes to credit. I'm sure you are as much aware as I am that assets in agriculture now total over a trillion dollars. This is, I guess, almost as much as all the manufacturing assets in the United States.

Farmers have a debt on that of over $200 billion. Of course, what disturbs me is that annual farm incomes have fallen to something like $22 billion. Paying off the $200 billion debt at 10-percent interest doesn't leave you much for agriculture, and I think agriculture has made a great contribution.

In your own statement you mentioned something about the prospect for greater price stability which is reinforced by the outlook for stability in petroleum prices and ample crops. And that's true about crop production and consumers in this country put only 16 percent—but in taking out liquor and cigarettes we're talking about a little over 15 percent—of their income into the big item of food. This makes it possible to make contributions to more prosperity in other areas of the economy. Then I think of what agriculture does in our economic picture with our exports. Agriculture exports are probably the only area that's showing a real, positive contribution to our balance of payments. Then in light of all that, I see the grain index go down and the livestock prices went down 14 percent.

Wages and salaries in the United States went up 10.4 percent and transfer payments went up to 13.2 percent while farm income went down 6 percent.

Now this disturbs me and sometimes I think that because they only make up 2.5 percent of the population, they are often times overlooked. I know in this very committee that I've said to the committee as a whole here that we rarely ever mention agriculture.

Does the current agriculture picture cause you any concern, in relation to its role in the overall economy and the doldrums which farmers find themselves in today?

Mr. **Volcker**. Yes. You point out that the agriculture sector is only 2.5 percent of the population. They have done an enormous job in this country, not only feeding Americans but also making a tremendous contribution to our balance of payments of tens of billions of dollars. At the moment, and for some months, agricultural prices have been steady or falling, even at the farm level, and helping to hold down those price indexes, but I understand there's a very considerable squeeze between the cost of production and the cost of crops at the moment and that sector is squeezed along with some others.

Senator **Abdnor**. Well, what disturbs me is we're striving for greater productivity and all, and here's agriculture—where output has increased 70 percent since 1950 while other areas have come nowhere near that. So we're not going to solve our problems in that area alone. So the activity is what we're striving for in many industries of this country but it's not necessarily so in agriculture. I'm just concerned that sometimes there's not enough consideration given to agriculture or its condition. I can tell you this, that we cannot get along without it. That's the thing that made America great. All you have to do is look at what Soviet Premier Brezhnev said in a recent speech. He said that the greatest economic and political problem facing his nation was the supply of food. What does the future look like in the area of our agriculture?

Mr. **Volcker**. I'll not pretend to be an agricultural expert, but agriculture has been suffering, I think, from some of the same forces that other areas in the economy are suffering from. They have had enormous increases in prices of inputs. Those are much larger in the aggregate than the increased interest cost, but they are also suffering from increased interest cost at the moment. These factors are impinging upon a situation in which agricultural prices have not been rising, and those lines have come close together, and incomes have gotten squeezed. I can't say anything in particular about the outlook for agriculture except that it is caught up in some of the same inflationary squeeze and some of the same problems of dealing with inflation and depend as much upon changing that trend as other sectors of the economy.

Senator **Abdnor**. Thank you. I guess my time is up.

Representative **Reuss**. Thank you. Senator Sarbanes.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Chairman Volcker, would you agree that the high interest rates have contributed to the slowdown in the economy and the turndown in economic activity?

Mr. VOLCKER. If you look at it in the narrow, immediate sense, yes.

Senator SARBANES. So anybody looking at the situation in housing and autos would have to attribute at least a good part of it to the high interest rates. Would you agree with that?

Mr. VOLCKER. Yes.

Senator SARBANES. Michael Evans said last week before the committee, "In our opinion, the proximate cause of the recession is clearly the over-restrictive monetary policies and the high interest rates dictated by the Fed last summer," and I take it you think there's at least some merit to that observation.

Mr. VOLCKER. That's a different question. The question is what would have happened to interest rates otherwise and whether we would have really been better off otherwise. I think that comes back to the question of whether you can expect the economy to continue to grow without recession in a highly inflationary environment with the prospect of still more inflation, and I would suggest to you that that is not a setting in which you could have expected continuing economic growth in any event.

Senator SARBANES. Well, is it the Federal deficits that contribute to this view that there's a highly inflationary environment?

Mr. VOLCKER. Yes; I think that is a factor.

Senator SARBANES. Do you agree?

Mr. VOLCKER. If I may just interject, there is some feeling that that environment is turning. I think that is correct, but we are only at a turning point.

Senator SARBANES. Do you agree that a 1-percent increase in the unemployment rate means an approximately $25 to $30 billion increase in the Federal deficit as a consequence of people no longer working and, therefore, not being wage earners and taxpayers and with those revenues lost to the Treasury, and people then drawing support payments out of the Treasury, so that the double impact of loss of revenue and increased expenditures because of the increase in unemployment amounts to about $25 to $30 billion for each 1-percent increase in the rate?

Mr. VOLCKER. I don't know about $30 billion, but over $20 billion; yes.

Senator SARBANES. Well, if your high interest rates are contributing to the downturn, to the recession and to throwing people out of work, and people being thrown out of work is contributing to the deficit and the deficit is what's prompting you to pursue your monetary policy, aren't you simply compounding the problem we're confronted with?

Mr. VOLCKER. You say "my interest rates." I don't think that is——

Senator SARBANES. You're the Chairman of the Federal Reserve. At some point you're going to have to take some responsibility.

Mr. VOLCKER. I wish I had that kind of power and could waive a wand and direct where interest rates are going to be in the market. I don't think those interest rates would be any lower if we were following inflationary policies.

Senator SARBANES. Well, I don't agree that a different policy would necessarily be inflationary. Suppose interest rates were 12 to 14 percent today. Would that be inflationary?

Mr. VOLCKER. No; not in itself, I don't believe that.

Senator SARBANES. No; it would put people to work, thereby cutting down the Federal deficit. It would reduce the cost of carrying the Federal debt, thereby cutting down the Federal deficit, and it would allow some of the interest-sensitive sectors of the economy at least to get off the floor where they are right now.

Mr. VOLCKER. When I express concern over the Federal deficit, as we discussed earlier, it's over the size of the deficit even adjusting for the influence of levels of employment or unemployment. I'm much less concerned over a deficit that is merely a reflection of the recession; I think that is manageable and not in itself something that is going to be disturbing to the financial market. It's the underlying deficits that continue year in and year out when the recession factor you mentioned is not there.

Senator SARBANES. That's a reasonable point, but you're compounding the problem. We had a 7-percent unemployment rate in this country in July. It was 8.9 percent in the latest figure, clearly going to go well above 9 percent. Do you think that the unemployment rate will continue to go up in the next few months?

Mr. VOLCKER. I think that that is likely, given the trend of things at the moment and given that unemployment is a——

Senator SARBANES. Let me just finish the observation. That increase of two points, 7 and 9 percent in the unemployment rate, is $50 to $60 billion on the Federal deficit.

Mr. VOLCKER. Let's look at what's happened since July. We have been providing more reserves to the banking system since July. We provided them at a reasonably rapid rate right through that period and short-term interest rates peaked, if I remember correctly, in July and came down rather steadily from July through November, I guess. They retraced a little bit, but they are substantially below where they were last July, and if we influence anything most directly we influence the short-term rates.

What's happened to the long-term rates during that same period? Despite the fact we were putting in more reserves, with the exception of recent weeks, we had a pretty steady decline in short-term rates. Long-term rates have not shown that favorable pattern. That suggests to me something else is going on out there that's beyond the direct, technical influence of the Federal Reserve.

Senator SARBANES. Jim Tobin last week before this committee said:

> The monetary navigators are piloting the ship these days. After all the rhetoric of 1981, the Federal Government's only anti-inflation program is the same as Mrs. Thatcher's in England, the same old remedy the previous administrations have intermittently tried. This is to depress monetary spending for goods and services and let competition of workers desperate for jobs and employers desperate for customers lower wages and price inflation rates. President Reagan and his three predecessors all swore not to use unemployment as a remedy for inflation. Every one of them has done so and encountered the same difficulties. The process is slow and painful. The difference this time is not in the stance of the President who is not Mrs. Thatcher but the determination of the Federal Reserve Chairman who tries to play the economic role of Mrs. Thatcher without the political clout and public rostrum of a head of government.

Unemployment in England, it was announced this morning, has gone over 3 million, 12.5 percent of their labor force, by far the greatest they have had since the Great Depression.

Are we being pushed in exactly the same direction?

Mr. VOLCKER. We have a similar problem. We both have difficulties in turning down the inflation rate. But I don't want to carry that analogy very far. You said in the past we have intermittently——

Senator SARBANES. It was not my statement.

Mr. VOLCKER. It was Mr. Tobin's statement; I understand that. He said we have intermittently had monetary restraint. I think the implication is that it was not carried through. The inflationary process accelerated instead of decelerated. I think that's part of the problem that we have inherited. Anti-inflation programs have not been carried through.

The kind of problem we have at the moment represents a culmination of an inflationary process that's been permitted to proceed over a period of time. I don't think you ever found me suggesting it would be easy to turn this around. I have argued that it's very important to turn it around because of the very objectives I'm sure that you share—stimulating growth and prosperity over a long period of time.

Senator SARBANES. Mr. Chairman, my time is up. I simply want to make this observation. It's my view that the high interest rate policy which the Fed is pursuing is, rather than checking inflation, in fact contributing to it. It becomes a cost which is passed on to the consumer. It is a significant cause of the recession which we are experiencing with millions of people thrown out of work which only compounds the deficit problem that we're facing, I also think it deals a very severe blow to productivity in this country. We have certain interest-sensitive sectors of the economy that are absolutely flat on their back—housing and autos, small business is being squeezed out, the family farmer is being squeezed out. I don't think it's a satisfactory answer, Chairman Volcker, to say to these people, well, that's the way it is. These aren't marginal enterprises we're talking about. These are highly effective producers who have been in business over sustained periods of time and they are going under because of these high interest rate policies. It's no comfort to them to say, well, you've got to go through the wringer. I'm very frank to tell you I'm becoming short tempered with those who counsel going through the wringer. They never go through the wringer themselves. They just give that counsel to everybody else. We have a lot of people now who have lost their jobs. Ms. Norwood testified before this committee that the additional 2 million people unemployed since last July, almost all of them, 1.8 million, are people who had jobs and have lost them and they are out there confronted with a situation that they can't cope with. Mortgage delinquencies are up. People are losing their homes. They are selling off their belongings.

Representative REUSS. Thank you. Representative Heckler.

Representative HECKLER. Chairman Volcker, the concern I have focuses on real interest rates and their cost to the marketplace. According to the CPI, for the 3 months ending December, we experienced 5.3 percent inflation at a compound annual rate. That leaves a real interest rate exceeding 8 percent for 3-month Treasury bills at yesterday's auction, and about 9 percent for longer term Treasury bills, and 11.5 percent for more typical issues. What do you calculate as the present real interest rate and why is it so far above historical rates of roughly 3 or 4 percent?

Mr. VOLCKER. The calculation you make of real interest rates relates the latest price observations or the latest interest rate observations in the market. I suppose, conceptually, a real interest rate can't be measured because it depends upon what people expect is going to happen to inflation over the period of time that they are lending the money. I think that we do see, in the kind of calculation you're making, an extraordinarily high level of real interest rates, just taking the current inflation rate against current interest rates.

The question is, How do you explain that and what are the prospects for that continuing? Part of the explanation lies in the fact that uncertainties about the future inflation rates still loom very high in the minds of many potential lenders. There is a very uncertain situation out there in the marketplace where long-term lenders in particular don't want to take a chance; for a long period of years inflation has turned out to be worse than they expected and interest rates have turned out to be worse than they expected, and they have taken losses and are reluctant to take too many chances on the situation improving. This comes back, in part, to Senator Sarbanes' observation.

I reject the characterization of "a high interest rate policy," because I think the only way we're going to get those interest rates down and keep them down is to deal with the underlying inflation process that gave rise to the problem in the first place. These interest rates are extraordinarily high at the moment.

The only optimism, if you will, that one can extract is that in the long run they will go down; as confidence is restored—particularly restored in the inflation outlook—I think we can legitimately look forward to a lot of improvement in that area.

That's not the only factor bearing upon interest rates and that's why I have not been silent about the budgetary picture which directly impinges upon financial markets and the level of interest rates in real terms as well as in nominal terms.

Representative HECKLER. Well, as you know—and you probably have heard as I have, from the savings and loan institutions, from bankers in that sector of the economy—those bank officials feel very strongly that interest rates are about 50 percent higher than they need to be. They feel that there are those who are profiting from the situation in which they find themselves, and could be persuaded with the right jawboning to take more sensitive steps and ease the crunch on the small business community, the housing industry, the automobile industry, and so forth.

Do you agree with that characterization?

Mr. VOLCKER. I don't agree that this is the situation in which we can expect jawboning to have a lot of impact over a period of time. There are some very basic and fundamental forces at work that I don't think are manageable by anybody's jaw. I suggest two things—and I'm sorry I sound so repetitive—but I don't think you're going to deal with this interest rate problem without inspiring confidence through public policies in general that inflation will be dealt with, and without working out the budgetary problem.

Representative **Heckler**. Do you agree with that characterization that the present level of interest rates is unnecessarily high, maybe 2 or 3 percent above what is needed, and strictly the result of a profit motive?

Mr. **Volcker**. They seem unnecessarily high to me in one sense, but I've got to deal with the market as it exists. I don't think we need these interest rates, that they are desirable in and of themselves, but I don't think that's any way to bring them down.

Representative **Heckler**. Another point is being discussed by economists—at least some economists—who take the measure of what the Fed is doing to the financial system by looking at the Fed's holdings of Treasuries and agency securities. Those were $121.5 billion on October 18. Open market purchases pushed them to $131.5 billion. Now they are down to $125.4 billion as of January 13, well above what they were this time last year. Some economists say this jump in reserves is the main reason for the present excesses in the money supply. They say the Fed should stop trying to manage the money supply, simply not monetize the debt, make the discount rate closely follow market rates, cease to target on Federal funds rates and cease to give signals to the marketplace about what and where the Federal funds rate should be—in essence, let the financial institutions expand and contract reserves and money supply according to demand.

These economists say this would take the Federal Reserve out of money management and interest ratemaking, and they say it might be a noninflationary way of letting market rates drop closer to inflation rates and let real interest rates drop to their historical norms.

What is your reaction to that point of view?

Mr. **Volcker**. The figures you cite largely reflect the short run, changes over the end of the year when there are very large seasonal movements. It is unquestionably true that our portfolio of government securities is higher now than it was at the same time last year because we do provide reserves through the year. I think your observation, together with Senator Sarbanes' and others, join the issue. I would presume the implication of his comments are that we should provide even more reserves; the implication of your comment is perhaps we should have provided less. We have to make some judgment between those courses, and we are following a course between those extremes and suggesting that the supply of money and credit should increase. That involves some increase of reserves. It did last year and will this year, but not too much.

What is too much is a matter of judgment, but I seem to find myself between two extremes at two ends of this table anyway. I think we have to provide and should provide some increase in reserves in a gradual manner over the course of the year, subtracting for seasonal ups and downs, to provide for some growth in money and credit, and that's what that injection of government securities reflects.

Representative **Heckler**. Thank you, Mr. Chairman.

Representative **Reuss**. Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

Mr. Volcker, big business can normally pass on interest rates but small business has to eat it. We have had an increase in small business bankruptcies of approximately 42 percent last year and for every small business that files for bankruptcy 8 to 10 close their doors and just give up. Yet housing is in the worst shape it's been in in 30 years. You've got car sales at about a 20-year low. You've got farmers with their credit ratings in the worst shape they have been in since 1934. You've got the delinquencies up 35 percent on farms and they tell us about 8 percent will not have the money.

I'm totally convinced we've got a recession coming from high interest rates. Now when you started out last year—when you finished up the last figures I saw showed that you were going for a money growth of 3.5 to 6 percent. The January 15 figures I saw on M_1 showed you came in at 2.2. In addition to that, we saw in the second and third quarter a reduction in the money supply on the M_1 basis and yet in the fourth quarter the increase was one where it looked like the spigots had really been opened up to over 12 percent.

Now we're not going to come out of this recession until we see a lowering of short-term and long-term interest rates and you're not going to get those until we can say to the American people that we have a stable and moderate expansion of the money supply, and I don't think that's what we've seen when we have seen those kinds of aberrations.

My question to you, Mr. Volcker, is, Are there tools you need? Was this change in the supply the result of your changing opinion as to what had to be done to bring down inflation? Did it result in those major changes in the cycle or was it that you just don't have the tools to accomplish the objective?

Mr. **Volcker**. We discussed this a little bit earlier, Senator. The increase in the money supply that happened in the last very few weeks, would be potentially disturbing if it were not temporary. I don't think the increases in November and December were in and of themselves of a proportion that were disturbingly large against the pattern of restraint that has been evident.

The question that you raised is, Is it desirable to iron out all of these fluctuations, can we do it, and would it be desirable to do it if we could do it? My own view of that is it wouldn't be totally desirable to do it to the extent that the demand for money is erratic. You would get more instability in the money markets by trying to completely iron out these short-term fluctuations.

I say that against a background of assuming that the trend is in the right direction, and I think the trend has been in the right direction. So, yes, there are things that you could do conceptually to put the money supply on a more even course. I think even then you're not going to get it on a perfectly even course from month to month or quarter to quarter.

Senator **Bentsen**. No; but there's a lot of difference——

Mr. **Volcker**. It's a practical question of how far you want to push in that direction.

Senator **Bentsen**. The second and third quarter, what you have on the M_1 basis, what looks like an actual reduction and then to go to the last quarter and have something in excess of 12 percent—that isn't even close.

Mr. **Volcker**. You had an actual reduction, as I indicated earlier, when you measure it from a particular brief peak that we had in

April. When you look at the quarterly figures—and I cited this earlier—just arbitrarily taking the calendar quarters, you had 2.1 percent, 1.1 percent, 1.9 percent, and 8 percent as shift-adjusted figures. You referred to the fact, as some of us have, that that adds up to 2.2 percent for the year as a whole, which was under the target that we had cited for that particular number. We ended up with some of our other aggregates on the high side. I myself would not put exclusive emphasis on M_1; I think that would be a mistake, particularly during the period when technological change is so rapid and the change in the habits and usages of money are so rapid. We have to look at a variety of indicators to get a fair representation.

Senator **BENTSEN**. Well, the problem is the money markets become unstable and we'd like it evened out more than that.

Mr. **VOLCKER**. I'd love to even it out perfectly if that had no——

Senator **BENTSEN**. No one anticipates that or expects that.

Mr. **VOLCKER**. I'd love to dampen it at least to the extent that can be done without running into more problems in other directions. I think that's the heart of the matter. It may be interesting to look at some of the figures in foreign countries as suggestive of the demand that operates on that particular M_1 number; when you compare our figures in a kind of international money supply league, our figures look relatively stable.

Senator **BENTSEN**. Mr. Chairman, I'm sorry I put my glasses on to read this note and it says my time is up. Thank you.

Representative **REUSS**. Thank you. Senator Symms.

Senator **SYMMS**. Thank you, Mr. Chairman. I have been tied up in another committee and I apologize for being late here but I'm very interested in this and I just would like to ask Chairman Volcker a question. Since the individual and corporations are so illiquid at this time, if we raise taxes on income and corporate earnings to finance erasing the Government deficit, what will be the response from the Fed? Won't that only force the Fed to monetize the growth instead of perhaps monetizing the debt? Since the individuals and corporations are so illiquid, if we try to raise taxes, aren't we trying to tax something that isn't there?

Mr. **VOLCKER**. I don't know just what kind of taxes you're thinking of. In the total cash flow of corporations you have to measure what additional tax burden you're putting on against that kind of figure. You're working, of course, against a background of a large decrease in corporate taxes already enacted. You're moving in a direction where the tax code as it stands is providing very considerable support for corporate cash flow.

I would think—and I literally do not know what kind of tax program you have in mind—that you would measure the impact in terms of billions of dollars, and you have to look at that in proportion to all the other changes that are being made.

Senator **SYMMS**. So then are you saying that raising taxes would not be a solution?

Mr. **VOLCKER**. Raising taxes is a part of the solution to some of the budgetary problems. It may not be as desirable as working on the other side of the equation. I think there is a budgetary problem.

Senator **Symms**. You think you would prefer if we just cut the budget it would then not create the problems in the private sector and the illiquidity?

Mr. **Volcker**. Cutting expenditures has problems of its own, as you well know, but from the standpoint of the particular problem you're referring to, the problem of general incentives and all the rest, the more you can do on spending, the better. You've got to put that in the context of social objectives, defense objectives, and others, but I don't think there's any question from the standpoint of rather abstract economic analysis that the more you can do on the spending side, the better off we will be.

Senator **Symms**. Well, along that subject, I personally am one Member that doesn't favor raising taxes, but if the Congress should decide to do so, would you advocate that the tax increases be consumptive taxes or increased taxes on earned and unearned corporate income if we had the choice to make?

Mr. **Volcker**. The Congress and the administration took a large step last year toward reducing direct taxation and larger income tax rates. I think there would be quite a lot to be said if you have to raise taxes to move in directions that are consistent with that pattern. There's the energy area and there are other areas that could be looked to in terms of tax increases, if tax increases are necessary.

Senator **Symms**. Mr. Chairman, with your efforts to try to control money growth and so forth with the mutual money market funds and all the other financial instruments that are now available in the market over which the Federal Reserve Board does not have control, do you believe that it's any longer possible to have a Federal Reserve be able to judge how much growth should occur in monetary aggregates that does occur?

Mr. **Volcker**. I think these changes make it more difficult, and those difficulties focus on M_1 more than on some of the broader aggregates because some of these changes just influence where the money is in the total. The broader the aggregate you look at, the less impact they have. When you look at M_1, for instance, you have to make a judgment of what influence the money market funds are under, what is the desire of people to hold money in the particular forms that we do include in M_1. One of the things that clearly went on last year—it's always hard to judge the precise magnitude, but the direction is very clear is that there was an increase in the popularity of money market funds. The ability to use money market funds as transaction balances is something that we need to take into account in judging what the appropriate level of M_1 should be.

One of the reasons we permitted M_1 to be as low as it was was evidence of the increasing use of money market funds as a substitute for M_1 type balances. We don't include those in M_1. When you look at that kind of evidence, together with the fact that the broader aggregates were not running low relative to our objectives, we were more willing than we otherwise would have been to permit M_1 to run low. These are the kinds of judgments that you inevitably run into in connection with these targets and in a period of rapid change in financial markets.

Senator **Symms**. Thank you very much, Mr. Chairman.

Representative **Reuss**. Thank you. Senator Mattingly.

Senator MATTINGLY. Mr. Volcker, just so we can remain consistent, you earlier testified that the M_1 growth for 1981 was 4.6 percent, but to be consistent with the rest of the figures you gave for 1979, 7.8, for 1980, 6.3, and then the shifted adjusted 1981 was 4.2. So we can be consistent, let's use that 1981 figure in the same unadjusted version which would be therefore 6.9, so it would be comparable to 1979 and 1980.

Mr. VOLCKER. I don't think that makes it comparable. That's the problem. We used the shift-adjusted figure in an effort to be more comparable.

Senator MATTINGLY. That may be true, but it's not the same comparison as the 1979 and 1980 figures.

Mr. VOLCKER. I guess I have to dispute that. You're right that the number was 6.9 percent in 1981, but all analyses suggest that that that raw number, particularly in the earlier part of the year, was for our purposes artificially inflated by a transfer of savings deposits and other sources of funds into NOW accounts—a kind of once and for all shift that we wanted to take out of the figure so we would have a figure more comparable to the previous year. We thought we had to adjust the raw number. You accurately cited the raw number, but analytically it had a different meaning because of the shift from——

Senator MATTINGLY. Well, then, my suggestion would be to go back and change 1979 which is the same thing we've been trying to get the Federal Government to do with the CPI.

Mr. VOLCKER. If I can just take a second of your time to say that this is an illustration of precisely the kind of problem that we all have and the markets have in interpreting a figure in the midst of, in this case, a legislated change. The Congress legislated a new form of money, and we tried to make allowance for the impact of that during the transitional period.

Senator MATTINGLY. My friend down on the other end, Senator Symms, tried to change the CPI so it would become a more accurate figure. We have a few big spenders still left in Congress and in just the last few months they consistently said the tax cuts that we gave last summer are the cause of the deficits for 1982. I think you and I both know that the personal income tax reductions only went into effect last October and were minimal while many of the other provisions of that tax reduction only went into effect some 26 days ago. The truth of the matter is that Congress has failed to control spending habits and it's indicated very well by the $710 billion in outlays for fiscal year 1982 and certainly when our economy is in recession I don't feel like any clear-thinking or sensible individual would advocate a tax increase which would further depress the economy.

Now faced with the continued slow rate of growth in the money supply this year, would you agree that a continued reduction in Federal spending coupled then with the personal tax reductions to take effect in July will stimulate the economic growth substantially?

Mr. VOLCKER. If you just look at the budgetary picture, yes, we do have a financial market problem here which I think has to be taken into account. I'm not talking about an increase in taxes right at the moment and I think it's too late to take massive expenditure action for the current fiscal year in the midst of the recession. I think your problem and the problem that's been inherited over a period of time is that expenditure-receipt lines are diverging and that that needs attention in fiscal 1983 and 1984. And if you're going to deal with a program to be effective in fiscal 1983 and 1984, I think your action is going to have to be initiated this year. That doesn't mean a program effective this year, but you've got to look at your options this year so that won't be sitting here in 1983 saying that the deficit is getting bigger and it's too late to do anything about it.

Senator **Mattingly**. Thank you, Mr. Volcker. Hopefully, Reaganomics and conservatives will take that into consideration in reducing the budget.

Representative **Reuss**. Chairman Volcker, you've said that if you could but wave a wand you would love to lower interest rates. Let me suggest two or three wands that you might wave which would do that.

One, I already have said when I suggested that the noninflationary 1981 M_1 target, 3.5 to 6 percent, would be noninflationary in 1982 and helpful.

Let me suggest a second wand. Last week we had before us three Nobel Laureates, Professors Tobin, Klein, and Leontief, all of whom agreed that an effective way to reduce the deficit and thus lower interest rates would be to defer the 10 percent personal income tax reduction scheduled for July 1, 1983. Do you agree or disagree?

Mr. **Volcker**. I would not want to suggest a particular move along those lines. I'd prefer to concentrate on the total and on the balance between the spending and the taxes. There have been some suggestions earlier that it is necessary to raise revenues; in my opinion, it is necessary to raise revenues if you can't do it reasonably in its entirety, on the expenditure side, in its entirety, although that certainly deserves priority. There are also other places one could look to do the job. These measures would have to be put into balance.

Representative **Reuss**. Well, let me just comment with some sadness that we made the Federal Reserve independent but at least would expect the Federal Reserve to tell it like it is and not be quite so vague.

Let me suggest a third wand. You pointed out in your statement that wages present an inflationary problem. Wouldn't it be helpful in the fight against inflation and the fight for lower interest rates if the administration withdrew its adamant opposition to any kind of an incomes policy, a social contract under which working people, for example, in return for wage moderation, could be given some compensations for their moderation?

Mr. **Volcker**. My concern about that is that it might be interepreted as waving an ineffectual wand. I could draw up or construct a vision in my mind that might parallel yours that this would be helpful in terms of achieving the right result if it were practical or workable. We have tried it in the past and never found it practical or workable, and there's been quite a bit of experience abroad, as well as in this country. Setting that forward as an answer to the problem if, in fact, it's not practical or workable, is, I suspect, not going to be of assistance but rather the opposite. With some reluctance, I do not think that's a practical or workable approach in the particular situation that we find ourselves in now.

Representative REUSS. Well, I regret that the products of the "Reuss Wand and Baton Factory" are not acceptable.

Mr. VOLCKER. It's not a question entirely of whether they're acceptable or not; it's whether they're workable or not.

Representative REUSS. Representative Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Volcker, I think we all know that we're confronted for the next 3 years with a possible Federal deficit which could be $500 billion or something a little less.

Mr. VOLCKER. I think that's too big.

Representative RICHMOND. Say $400 billion. Wouldn't you say that $400 billion of Federal deficit that is overhanging the market probably is the most inflationary thing we have going for us right now and also is the one thing that guarantees high interest rates because the only way you're going to raise that $400 billion is by selling Treasury bonds at auction. Now, again these Treasury bonds, unlike the Japanese postal savings bonds which are fixed at 5.75 percent——

Mr. VOLCKER. That's what I've been saying.

Representative RICHMOND. You have to go out every few weeks and auction off your Treasury bonds to the highest bidder.

Mr. VOLCKER. That's correct. Those auctions are very frequent these days.

Representative RICHMOND. And that in itself would guarantee high interest rates and a continuation of inflation. Therefore, the other side of the coin is that we'd better try to reduce Government expenditures or increase Government income by $100 billion a year? That would help an awful lot, wouldn't it?

Mr. VOLCKER. Yes.

Representative RICHMOND. A number of us have been working on this "share the burden" budget which involves excise taxes on luxuries, removing the deductibility of consumer credit, which involves increasing the gasoline highway user tax and many other revenue-enhancing measures, and it comes to $44 billion. We can't seem to sell it to the administration. Many of the people in the administration like it. The idea of getting equity in our tradings with Japan is another $30 billion. The idea of touching that white elephant over at the Pentagon for another $20 billion. You could pick up $90 to $100 billion, thereby reducing interest rates, reducing the rise of inflation, just by a series of intelligent "share the burden" taxes, by getting equity from Japan, and cutting our defense budget somewhat.

Mr. VOLCKER. I agree, if there's a will there's a way, and there are a number of ways to go about this and, of course, that's what your problem is all about, sorting out those ways to get it done.

Representative RICHMOND. Do you feel if we could reduce the Federal deficit it would help you with your interest rates more than any single thing we could do?

Mr. VOLCKER. Yes.

Representative RICHMOND. Thank you, Mr. Chairman.

Representative REUSS. Representative Wylie.

Representative **Wylie**. Chairman Volcker, it's my impression that many observers of monetary policy, including perhaps myself, believe that increasing the rate of open market purchases of Government securities could lower interest rates in the short term, but the short term would be very short and as soon as the bond market concluded that the Fed was following an expansionary policy a reaction would set in and the price of Government securities would fall and interest rates would rise to higher levels than before the expansionary policy was initiated. Do you agree with that description of what could happen if the Fed tried to lower interest rates by accelerating the money supply?

Mr. **Volcker**. Yes, in a general way, I agree with that. If we would now deliberately buy Government securities without any guidelines on credit expansion and our action was interpreted as you suggest, I think that's the result you would get.

Representative **Wylie**. OK. I think everyone on this panel this morning agrees that we have to decrease the deficit. At least I didn't hear any disagreement to that. I guess the ultimate question is how do we go about that? I don't think we can decrease the deficit very much unless we decrease the increase in defense spending some and it's been suggested that perhaps a lot of increased revenues from taxes. It was speculated for a while that there would be an increase in the tax on booze and tobacco. Were you involved in any of the discussions on that?

Mr. **Volcker**. No, not in any of the specifics of that sort. I don't participate in the administration councils about those kinds of political or economic decisions. I have engaged in discussions about the importance of dealing with the deficit.

Representative **Wylie**. I happen to think that might be a good source of revenue. Do you agree or disagree?

Mr. **Volcker**. It is a source. It's a source that doesn't seem to me to damage incentives in the same way some other tax increases do. But you have to make judgments, as your comment well reflected, as to what to do about defense spending, social programs, entitlements, what to do about a variety of taxes, all of which are essentially political decisions that you have to sort out. I think all I could do is just emphasize the importance of dealing with the situation from both sides, if necessary, ideally from the spending side in purely economic terms. That's the selection process that you really have to sort out.

Representative **Wylie**. Well, I think that's true. I rather expected that kind of answer. I think the key words in your answer were damage incentives. I think that's what we have to look to, a source of revenue that would not damage incentives, and I don't think we want to look at the source of revenue that Steve Symms was suggesting—not as a possibility but as a source that somebody was talking about. Thank you very much.

Representative **Reuss**. Thank you. Senator Proxmire.

Senator **Proxmire**. Chairman Volcker, as you know, I have generally supported your policies, although they do pose some difficulty, and I agree wholeheartedly also with your argument that the greatest favor we could do for you is reduce the deficit sharply. On the other hand, you don't put people back to work by cutting spending and raising taxes and we do have almost 9 percent of our work force—maybe more than that—out of work now.

The difficulty seems to me to be that you're the only anti-inflation game in town and that's why you have taken something of a beating here this morning and why you continue to be criticized so generally throughout the country and even in Presidential press conferences. Why should you be the only game in town? Wouldn't it help you to get part—I want to return to what Chairman Reuss was suggesting, but before that—antitrust, the best regulator we have—the best element we have in controlling prices is the market. We don't have an effective market unless we have effective competition. We have a situation now where we have wholesale mergers, including DuPont's swallowing Conoco and United States Steel and Marathon Oil. The Bureau of Competition of the FTC is being starved and may be knocked out of operation. They are the only agency against fixing prices. We have a head of the Justice Department's Antitrust Division, Mr. Baxter, who said he favors permitting manufacturers to fix retail prices. All of that seems to me to be inflationary. We have a free trade policy which is being badly eroded with the trigger prices on steel being invoked, with restriction on imports of automobiles, all of which would be most anti-inflationary in a period of time where, as we know, the only real competition we get in automobile and steel in price competition is abroad.

And finally on incomes policy. Now your response to the chairman is, it's been tried and hasn't worked. I submit it has not been tried. The program has been proposed to us by eminent economists that we should have a tax-based incomes policy that would provide an incentive to labor unions and to employers to hold down wages by giving them a tax break if they didn't or a tax penalty if they increased their wages, and at the same time a kind of incentive for price behavior that would be anti-inflationary on the part of manufacturers.

And finally, you say it's been tried and hasn't worked. It has worked at times in the past. I think all of us recall the action by President Kennedy in talking big steel out of inflationary price increases in 1962. It worked. It worked. It was tough but it worked.

What's wrong with having a comprehensive anti-inflation policy? Sure, we need stronger fiscal policy. Yes, we need your continued steadfastness in holding down the increase in the money supply. In addition to that, don't we need these other programs? And if we do not have those other programs, don't we have to pay a higher price in unemployment because we don't have them?

Mr. VOLCKER. My general answer to you is "Yes." I fully agree with what you have said about the competitive side. There are many regulatory practices, for instance, to look at. We tend to get in these hearings and emphasize monetary policy and fiscal policy, and we don't concentrate enough on the importance of some of the things that you have mentioned on the regulatory side of things.

On the incomes policy in particular, I don't think I would change the answer that I gave earlier. I have looked at the tax-based incomes policy that you referred to. We have one member of the Board of Governors, as you know, who's been quite enamored of that possible approach. I've looked at it in the past and said maybe this is worth experimenting with, but when it comes right down to it, and I look at the specifics and look at what people have proposed operationally—in fact, the proposals don't get to an operational level because you begin running into the problems before that—I find it becomes pretty arbitrary looking.

Broadly and conceptually I agree with the way you have stated these approaches, but many people think of them as a substitute for fiscal, monetary, and regulatory policies. To the extent we substitute this kind of thing for the other policies, instead of as a supplement, then I think they will not work. That's always been the temptation in the past. You look at these as kind of "easy substitutes," if I may put it that way. Whatever their value is, I'm sure they're not going to work in that kind of context. That's not at all what you suggested, but I suggest there is a practical temptation to look at them in that way.

Senator PROXMIRE. I'd just like to ask one other question not related to that because my time is up. We had a peculiar pattern of interest rate increases since early December which is quite disturbing. Interest rates did come down with the recession and for other reasons, primarily because of your policies, but the 3-month Treasury bills, for example, have been going up—went up from 10.4 on December 5 to 12.5 percent; conventional mortgages are up from 16.9 to 17.4 percent and rising. How do you explain that? Do you think this trend is likely to continue?

Mr. VOLCKER. I hope not. It hasn't gone on long enough to suggest that it's all that exceptional in the light of history, but it's unusual in a period of recession to see either an increase in the money supply or an increase in interest rates of any magnitude that persists against that kind of background.

Senator PROXMIRE. Isn't that disturbing because it suggests——

Mr. VOLCKER. Yes.

Senator PROXMIRE. It suggests as we recover we're likely to run into what Henry Kaufman warned us against as a sharp rise in interest rates that will choke off recovery as it did in 1980 and 1981?

Mr. VOLCKER. It's a kind of warning in a way that those kinds of concerns and doubts exist out there. I think part of the explanation is a kind of anticipatory concern that some market people have been expressing. If people expect it strongly enough they don't wait for it to happen; they anticipate it in their actions. There are other more immediate factors that affect this. Interestingly enough, here again, we see a pattern where long-term rates, if you go back to late November or December—I don't remember the exact timing—reacted as much or more than short-term rates, which is unusual. You ask yourself why did this happen? It suggests there's an element of anticipation and that would coincide in part not only with the more general concerns you cited but particular concerns about the budgetary picture. I just think we cannot escape the anticipatory kind of reaction when the market is concerned about that dimension of policy. The increase in the money supply itself has certainly led to some anticipations at least for short-term rate increases; it's been interesting that this sharp increase in January has been accompanied by some increases in short-term rates, but not so much in long-term rates. The short-term rate reaction often happens when you get a short-term bulge in the money supply because the markets anticipate that we will not be providing the reserves to support that and they feel, in the very short run, that may add to pressures on the money market. That's not disturbing if it doesn't pass through to the long-term markets, but very often these things have been passing through to the long-term markets.

Senator **Proxmire**. Thank you, Mr. Chairman.

Representative **Reuss**. Thank you.

Representative **Rousselot**. Mr. Chairman, in the past—and I have been attending these Joint Economic Committee hearings where you have testified and you did it again today briefly, you have zeroed in on the necessity to bring inflation under control of reducing our spending levels at the Federal Government level. Now as you know, we didn't really reduce spending for 1982. We just slowed down the increase. Do you think as we look at our appropriations bills which we haven't completed that we should continue to find ways to stress spending? You have put tremendous emphasis on that in the past.

Mr. **Volcker**. Yes.

Representative **Rousselot**. Well, if you were in our place, how much do you think we could reduce what we have left of our 1982 spending bill?

Mr. **Volcker**. On 1982, I don't think you can do a lot.

Representative **Rousselot**. Can't do anything?

Mr. **Volcker**. I'm not going to say "anything." You're more of an expert on what can be done and what's practical in 1982 than I am. My primary focus is beyond 1982.

Representative **Rousselot**. So you don't think we can do much in the appropriations bill we have left for 1982?

Mr. **Volcker**. Quite frankly, I have not looked, for instance, at what problems there may be in those appropriations bills actually exceeding the targets set in the budget resolutions. I literally am not well enough informed to comment in detail on the 1982 picture.

Representative **Rousselot**. You did stress 1983. How much do you think we can reduce the proposed spending for 1983?

Mr. **Volcker**. I think you could do quite a lot, but what are you going to mark "off limits?" And this gets to the heart of the problem that you and others have to face. Is there nothing that can be done on defense, on entitlements? Does it all have to be in a relatively limited sector of the budget? I don't know the answers to those questions, but I say if so many programs are off limits, then I think you're forced to look at the revenue side.

Representative **Rousselot**. Well, assuming that nothing was off limits, what do you think we could do and about how much could we save in increased spending? Because you have always emphasized that so strongly. I happen to agree with you and I don't think anything should be off limits.

Mr. **Volcker**. I said last fall, when I looked at this problem as carefully as I could, that looking ahead to 1984—I'm going 1 year beyond what you're suggesting, but you want to get on this trend—you were in the neighborhood of a problem that seemed to me to require something like $100 billion of action, whether it came from the spending side or from the revenue side; that's spread over a 2-year period.

Representative **Rousselot**. $100 billion?

Mr. **Volcker**. Yes, or over a 3-year period beginning now.

Representative **Rousselot**. $100 billion in 1983 and 1984?

Mr. **Volcker**. Yes.

Representative **Rousselot**. Since we're in the process of marking up our budget bills for 1983, how much do you think we should save on the spending side in 1983?

Mr. **Volcker**. I think all you can. I don't know that I can be any more specific.

Representative **Rousselot**. That's pretty tough to vote that way—all you can.

Mr. **Volcker**. I understand it is. Obviously, you're looking for some tens of billions of dollars to get on that kind of track.

Representative **Rousselot**. And across the board in all areas of spending?

Mr. **Volcker**. From my point of view, if you don't do it in one area you've got to do it in another, and I'm very reluctant to say it should be in one area or another. I haven't studied it.

Representative **Rousselot**. I tend to agree with you. Percentagewise, then, if you won't give us a dollar figure, What do you think it should be?

Mr. **Volcker**. When you get into the tens of billions area, you might be talking 3 or 4 percent. That figure is strictly off the top of my head.

Representative **Rousselot**. You don't think we can do anything in 1982 on our appropriations of any significance?

Mr. **Volcker**. I simply do not know the state of play. If you're coming in with a lot of appropriation bills that in their present form exceed what the Congress and the administration had agreed to 6 months ago, I would certainly think something could be done, but I've not looked at this picture in any detail. I can tell you that that appropriation bill or this appropriation bill is high relative to what the Congress agreed to do some months ago, but I would hope that there's no "reverse English" on that process and that you don't come out with higher spending than what you set out to do earlier.

Representative **Rousselot**. Thank you, Mr. Chairman.

Representative **Reuss**. Representative Heckler.

Representative **Heckler**. Thank you. Chairman Volcker, as you know, we continue to be plagued with very serious problems in the housing field, in the thrift institutions—and salvaging the thrift institutions remains a nagging and terribly important burden on our society, on our whole economy. Various approaches toward solving this problem have been suggested. The all-savers certificate has failed the mark and has not lived up to the expectations of those who believed in it. What do you believe is the best approach to those problems and their economic chances of success?

Mr. **Volcker**. I can give you one short-term suggestion and then I'll make a longer term comment. My short-term suggestion is that the Congress pass the bill that we proposed some months ago. When I say "we," I mean the regulating agencies with responsibilities in this area. That would facilitate, where necessary, mergers of those institutions, but would also enable the FDIC or the FSLIC to provide additional capital for institutions that can remain viable to help them over this difficult period.

I would urge that you get to work on that legislation which has already passed the House by a great majority; the Senate should deal with that particular piece of legislation.

My longer term comment—and I would hope it's not in a very long-term perspective—is that the basic answer to their problems has to be related to getting interest rates down. When you talk about monetary policy, when you talk about budgetary policy, anything that goes in the direction of reducing these extraordinary interest rates is the real answer to their problem. There isn't a lot in between the short-term support with that piece of legislation and the basic solution of getting the interest rates down which, in turn, rests upon the inflationary outlook and the budgetary outlook in considerable part. There is legislation proposed for broadening the authority of thrift institutions. I think there should be somewhat broader authority, although you might not want to go as far as some proposals. It's not going to help this short-term problem because they've got all the dead weight in their long-term portfolios, and there's no way you can eliminate the immediate strains.

Representative **Heckler**. Well, we're faced with the possibility of 20 or more bank failures in Massachusetts over the next year and I don't think that's an unrepresentative situation. It's quite commonplace throughout the country. The fact is, I really wonder how much of a cure-all the question of allowing the mergers of institutions would be.

Mr. **Volcker**. It's not a solution in capital letters. It's a means of handling a very distressing situation in a reasonable, orderly way, but I don't set that forward as an inviting fundamental solution to the problem. It's not a fundamental solution.

Representative **Heckler**. Getting to a more basic question, I think the hardest question to answer are the ones that come from "Main Street," and the question I get from "Main Street" in my district is, When is this recession going to bottom out? I don't know exactly how to answer that and I wonder how you would respond?

Mr. **Volcker**. What's going to have a lot to do with that question is the performance of the financial markets in the coming months. I think that's where the emphasis ought to be placed, and I won't repeat the fundamental things that I think are necessary to help assure that that turns out favorably.

Representative **Heckler**. You're saying the key factor is the performance of the financial markets?

Mr. **Volcker**. That is one key factor, yes.

Representative **Heckler**. Would you elaborate?

Mr. **Volcker**. Let me say in terms of assessing the business outlook, you have a lot of support from the Government in the most general sense. This large injection into the incomes stream from the deficits tends to support economic activity. You've got a tax cut coming along. I haven't heard any conversation this morning to change that situation appreciably; in fact, there have been a lot of comments in the opposite direction. I think there is a lot of support for the economy out there in terms of general fiscal policy. The problem is blending that with a set of circumstances that can help relieve some of these financial pressures in the market.

Representative HECKLER. Well, what performance by the financial institutions would be most beneficial toward the end of achieving an early end to the recession?

Mr. VOLCKER. By the financial institutions?

Representative HECKLER. By the financial institutions.

Mr. VOLCKER. What we would like to see is the situation in which financial institutions confidently go forward and lend money at lower interest rates for longer terms, but I think the problem we're coping with is how to create the environment in which they will do just that. That's the essence of the problem, as I see it, and they are not going to do it by us telling them to do it. They are going to do it when they see policies in place and gain the confidence that that kind of policy is going to pay off in their own terms.

Representative HECKLER. What would you say to those who criticize the high interest rates now, and say they could be reduced by three percent without any real problem because they are unduly high? Do you think that's a totally invalid comment made by people from the housing industry?

Mr. VOLCKER. I think it would be very helpful to have those interest rates down, most of all to housing. That doesn't tell me how to do it and, again, I simply come back to saying that it is that kind of objective in the immediate sense that ought to motivate a lot of our policies. That comes back, in a very fundamental sense, to saying that that prospect is impeded rather than assisted if the total complex of policies is interpreted as one of relaxation toward inflation or, worse yet, even inflationary. Given this very severe situation in which we find ourselves it would be counterproductive to say, "Well, let's forget inflation now." Forgetting about inflation will produce precisely the kind of financial conditions we don't want.

Representative HECKLER. I can understand that point of view. At the same time, we have already worked on inflation very substantially. We have made substantial progress.

Mr. VOLCKER. We are beginning to make progress.

Representative HECKLER. How much is enough? When will business start to have a little confidence and realize that perhaps we're serious? How far does the Congress have to go?

Mr. VOLCKER. Just looking at the budgetary situation, for instance; I don't think you're in a totally convincing posture now when one looks at the budgetary outlook, not in 1982 but in the ensuing years.

Representative HECKLER. My time is up.

Representative REUSS. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Chairman Volcker, thank you for your patience here today. I know we have kept you here for a long, lengthy period and as you may well imagine there are a great many people in the world that think that Paul Volcker gets up in the morning and decides what interest rates are going to be today or tomorrow or whatever the case is, and I think that, as I asked in my first question about all the other things that you don't control in terms of money market funds and so forth, it is a true statement, is it not, to say that the Federal Reserve Board has a monopoly on the control of the creation of new money and that you have to react to what the Congress does as far as covering the deficits? Is that true?

Mr. VOLCKER. A lot of the latter is certainly true, but I would not in today's circumstances say we have a monopoly on the control of the creation of new money. The funds go out and devise, as they are free to do, a method of creating money. They say, "You keep your money with us and we'll let you write a check on it." Well, that's money.

Senator SYMMS. Well, I think you're helping me make the point that I'm trying to make to get to the question I hope I can get to. As I see it, the problem that you're given is to try to make this thing work in a very complicated situation when you don't have full control over it and yet the Fed is the only source of legal tender, so to speak, in this United States. Do you think that, as most monopolies have a difficult time operating satisfactorily and have a very hard time having someone measure their performance, would some form of competition to the Fed insofar as gold, silver, other currencies, make your job easier as a way to measure what the performance of the Fed is?

Mr. VOLCKER. In some sense we've got that competition now; it depends upon how you measure it. Prices vary all over the market, and I think to some extent that reflects the hopes and fears and expectations of a lot of people about the value of currencies.

Senator SYMMS. But we still have a tax transaction on the exchange of the competition. People have to pay taxes on the difference in the price of it. So it does distort it somewhat, is that not correct?

Mr. VOLCKER. Taxes are always a distortion. I think the basic competition comes through in those markets, but I'm sure they're subject to tax distortion.

Senator SYMMS. As you're well aware, there's a great move among certain parts of the Reagan administration toward bringing about a dollar that would be as good as gold and Milton Friedman often refers to some of the fixed gold exchange rate suggestions as a pseudo gold standard and comes back to the point about competition. That's why I'm asking the question.

Mr. VOLCKER. I appreciate very much the kind of circumstances you were referring to initially, the complexity of the market, the difficulty of measuring money, the difficulty of judging changes in demand as well as supply. Those are the kinds of problems that you can try to deal with conceptually by looking to another standard. When you talk about fixing the price of gold—which is what the gold standard is going to be in one guise or another—then you have something concrete to compare with the difficulties of the present system. There are a lot of difficulties with the gold standard, too, and a lot of instabilities that impinge upon the gold market, but I recognize your point. I think what I would object to—not anything you've said but to the impression that is conveyed by some people when they talk about this subject—is that there's some magic and easy way to deal with these problems; if you only take that step or another step somehow people will wake up in the morning and have their expectations and behavior revolutionized. I don't see that kind of thing.

Senator SYMMS. You don't see it as a utopian answer?

Mr. **Volcker**. That's right.

Senator **Symms**. My own opinion would be that the best way to achieve getting a dollar as good as gold, which I think would be a laudible goal, would be to allow the price of gold to float and just allow the exchange of gold back and forth for dollars and allow people to use it as money as a competition to the Fed without having a tax transaction on it and then it might give you another way to measure a very difficult measuring stick. The reason I asked that question is I was in Hong Kong, just last week, and in a discussion there with a group of businessmen, some of which were bankers, their criticism of our system is that we try to do too much regulating and have too strong a central system. Two of the people from banks there told me they thought we would be better off in the United States if we had a less regulated banking system than we have and we would be able to control inflation better. Would you want to comment on that. In other words, less of a monopoly and more competition.

Mr. **Volcker**. I suppose my answer is, yes and no. In some areas I would agree with that. In other areas I would not. Let me give you a specific that is a terribly difficult problem for all of us now. Looked at from some points of view and looked at over a period of time, I certainly think we would be better off without some of these arbitrary inhibitions we have on banks competing with the open market or with money market funds in terms of interest rate ceilings. But we're caught in a situation right now—as, Mrs. Heckler's question suggested—where we have to deal with that competitive problem in the context of the very severe pressures that exist at least transitionally for thrift institutions. We can't progress as far as we would like in terms of freeing up the banking system for competition because we have to look very carefully at the thrift problem. When you're looking at a general guide for monetary policy, and for the dollar in particular, the answer for the dollar is whether it's stable or not. We can measure that in a general way through price indexes and, I suppose, in the end, cutting through all the business about the money supply and many other techniques of monetary policy, what we're interested in is the stability of the dollar. We can measure it not just in terms of gold or silver or any particular commodity, but in terms of the average price level. Money functions well when it's stable, and that's the kind of stability that we're interested in in the end.

Senator **Symms**. Thank you, Mr. Chairman. Mr. Chairman, if you would indulge me for one more question. Mr. Volcker, if I understand you correctly—and I do personally have some criticism, not of you, but of the institution of the banking system and of the Federal Reserve System, but be that as it may, under the present circumstances and the rules of the game that you're forced to play under, is there any way that you will be able to achieve stability of the dollar and stop inflation if the Congress continues to set 90 percent of the budget off limits to spending cuts?

Mr. **Volcker**. You could only do it at enormous cost. I think theoretically you could probably do it, but I agree very much with a comment that Senator Proxmire made earlier, that there's too much of a burden on monetary policy alone and if it's going to be monetary policy alone, then the strain, the pain, the difficulties are going to be greatly exaggerated from what they need to be.

Senator **Symms**. In terms of human tragedy because of high interest rates?

Mr. **Volcker**. That's right.

Senator **Symms**. So what you're saying is what we have to do is to take those sacred cow parts of the government that thus far have been set off limits to spending restrictions and include them in the overall aggregate, primarily talking about entitlements which make up 60 percent of the budget?

Mr. **Volcker**. As a practical matter, I don't think you can exclude such large parts of the budget.

Senator **Symms**. In terms of human tragedy from your perspective under our system that we're working under and assuming there's no major changes in the dollar standard in the next 2 years or say 12 months, the only way that you can see to bring about precipitous drops in interest rates would be a reduction of Government spending?

Mr. **Volcker**. Reduction in deficit certainly and I think the spending side has to be a major element in there. There are other major elements. Of course, again, when we're talking about reductions in Government spending we're talking mostly about the decrease in the rate of increase.

Senator **Symms**. Well, I'm talking about taking the 60 percent of the budget that's so-called entitlements and including them in for a reduction not in current benefits but a reduction in future benefits so we can bring about an easing of the policy of the Fed so people trying to buy homes and so forth can do so and our basic industries can grow.

Representative **Reuss**. If our country should decide to junk our present monetary system and go to a commodity system based on such commodities as gold or silver, would you be willing to give consideration to including in the list of commodities beaver pelts which served our land well during the French and Indian wars and of which the State of Wisconsin is a major producer?

Mr. **Volcker**. What I suggested is that when one looks at the stability of the dollar one would rather look at the broad index. I suspect beaver pelts would be a very small component of that index, but in itself I wouldn't exclude it.

Representative **Reuss**. On that happy note, I want to thank the members for their diligence, the witness for his patience, and the press for its alertness. We stand in recess until 10 o'clock tomorrow morning.

[Whereupon, at 12:40 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, January 27, 1982.]

THE 1982 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 27, 1982

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 318, Russell Senate Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Richmond, Brown, Heckler, Rousselot, and Wylie; and Senators Abdnor, Symms, Proxmire, and Sarbanes.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, assistant director; and William R. Buechner, Kent H. Hughes, Paul B. Manchester, Deborah Matz, Mark R. Policinski, Douglas N. Ross, Richard Vedder, and Robert E. Weintraub, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for its further hearings into the state of the economy.

We meet this morning with the Nation in a deep recession, with 9.5 million unemployed, less than three-fourths of the Nation's plant and equipment in operation, interest rates high and rising, and the specter of $100 billion deficits hanging over us. All of this stands in stark contrast with the bright promises of high growth, high employment, and low interest rates delivered to this committee by the administration just 1 year ago.

Last night the President addressed the Congress and the Nation. He didn't acknowledge the failure of his program. He didn't offer a single new initiative addressed to the reality of recession and unemployment today or which begins to meet the problem of record deficits in future years. The President is standing pat.

This morning we welcome our friend, Treasury Secretary Donald Regan, who has been before us many times in the past and whose counsel we always welcome.

Congressman Brown.

OPENING STATEMENT OF REPRESENTATIVE BROWN

Representative BROWN. Thank you, Mr. Chairman.

Secretary Regan, welcome to the committee hearings this morning. We on the Joint Economic Committee know a great deal about supply-side economics, since it began here—at least it was originally articulated here about 5 years ago. It's good to have you before the Joint Economic Committee because you have been the Cabinet's most articulate spokesman for the administration's program. I hope that today we can explode some of the myths about the President's program and supply-side economics.

The first myth is that the tax cuts of last year caused the recession. The economic think tanks tell us that the recession began in June or July. The tax cuts did not take effect until October, so how they caused a recession that began before they were put in effect is beyond my comprehension.

In addition, those tax cuts were much smaller and 9 months later than others of us on this committee, including Senator Bentsen and myself, had originally recommended and one can only believe that had the original tax cut been passed, the recession's impact would be less severe. I wonder how many of those who are now publicly wringing their hands over the recession worked last summer against larger tax cuts which would have lessened and maybe avoided the recession we are in.

You know the bottom line is that the tax cuts, which are just starting to have an effect, did not cause the recession, but they sure as heck are going to help end it.

The second myth is that the monetary policy of the past year was what the administration had in mind, and what the Joint Economic Committee had in mind, when it asked for a gradual, consistent reduction in the growth rate of the money supply. As I think we can show later on, the Fed is still on a rollercoaster monetary policy that swings from too tight to too excessive, which seems to be what they have accomplished or seems to be what has happened, whether it's been by design or not. In retrospect, the Fed, by letting the money supply contract from April to October of last year, pushed the economy, that had been weak for almost 2 years, into the present recession, in my opinion.

The third and most basic myth is that supply-side economics has failed. The simple truth is that so far little of the supply-side package has been in operation long enough to have any effect on the economy. The only major policy change that took effect in 1981 was an extremely tight monetary policy for 6 months, which is precisely what was recommended, and I'd like to explore how well that could be controlled.

Doing away with these myths will do a great deal to stop the confusion that is rampant in this town.

One other thing, Mr. Secretary, that I think you should know. During the past month of recess, I had the opportunity to meet with a great many fellow Ohioans. There are few States that have been hit harder by the recession than Ohio. But I tell you, many Ohioans are realistic in their view of the economy's future. Secretary Regan, they are worried about the recession but they also understand that you cannot find economic success in a few months after decades of decline. It does take time. We did not get into this situation in the last 2 or 3 months. As a matter of fact, we probably got into it in the last couple decades and we will not come out of it in 2 or 3 months. There seems to be a residual confidence in not only the President but in the system that he has proposed, at least the policies that I have seen, and they are of some personal interest to me, seem to verify that. So I have a feeling that, never mind what the press and this community says or what some of the members of this committee may say, there is confidence still at home in the President's program.

I think the time for economic renewal is at hand and certainly the folks at home seem to want firm action taken by this administration to get us back in shape.

So, Mr. Secretary, keep that warming thought in mind as some on this panel will attempt to shred that to little pieces this morning.

Representative Reuss. Congressman Richmond, I'm sure you're not a shredder, but maybe you would like to make an opening statement.

Representative Richmond. No, thank you.

Representative Reuss. All right, before we hear from Secretary Regan, I have three opening statements to submit for the record, without objection.

[The opening statements of Hon. John H. Rousselot, Hon. James Abdnor, and Hon. Paula Hawkins follow:]

Opening Statement of Representative Rousselot

Secretary Regan, I want to welcome you to our annual hearings on the economic outlook. I am anxious to hear how you believe our economy will perform in 1982. Speaking personally, I believe that if the Federal Reserve conducts monetary policy properly, hits its target and dead center, we will have a strong recovery this year and at the same time inflation will continue to taper off and interest rates will also fall.

I know that not everyone will agree with me. Many focus on the large deficits that are projected for 1982, 1983, and 1984 and argue that we face more, not less inflation, and higher not lower interest rates, in the years ahead, and therefore that we cannot have a sustained recovery. I disagree.

I am, of course, unhappy with the deficits that loom ahead. We have to cut spending, and do so more than most think it is possible to do. We have to remember that it is not the deficit but total Government spending that must be crowded out of the private sector. We can crowd out by taxing private spending and incomes, by dissipating the value of the dollar in inflation, or by selling bonds to the public. How we finance the deficits will determine what we crowd out. But there will be crowding out whether we close the deficits by raising taxes, finance them by selling bonds or finance them by printing new money.

There is no pleasant way of financing Government spending. In 1968, Lyndon Johnson used surtaxes on personal and corporate incomes to do the job. He believed that this would ease the pain of the spending we were doing then—that it would keep inflation and interest rates down. It didn't. Check the record. Inflation and interest rates rose within 6 months of the time Congress passed the surtaxes.

In 1977, 1978, and 1979, the Carter administration pushed through major spending increases and financed them: (1) by printing new money at nearly 8 percent per year; and (2) by allowing "bracket creep" to increase taxes. As a result, the deficit fell in 1977 from 1976, in 1978 from 1977, and in 1979 from 1980. However, that did not keep inflation and interest rates down. Both rose. The 90-day Treasury bill rate, for example, increased from under 5 percent in late 1976 to over 12 percent in December 1979. The CPI, which had increased only 4.8 percent between December 1975 and December 1976, increased 6.8 percent in 1977, 9.0 percent in 1978 and 13.3 percent in 1979. And, in 1980, the higher inflation and higher interest rates caught up with us. The economy collapsed and the deficit rose.

So I would not recommend our now closing the projected deficits by raising taxes and printing money. I say—let's do the impossible. Let's cut Government spending and make room for real growth and, if deficits remain, let's finance them the way corporations, States, and local governments finance their deficits—by selling bonds.

That is the honest way. The existence of those bonds will be a constant reminder that we have to rein-in spending more and more and more.

Mr. Secretary, I hope you will shed some further light on the question of the Government's finances. I am anxious to hear your testimony.

OPENING STATEMENT OF SENATOR ABDNOR

I am pleased to join my colleagues in welcoming you to this hearing, Mr. Regan. Yesterday this committee had the honor of hearing from Mr. Volcker of the Federal Reserve System. I took that opportunity to impress upon Mr. Volcker the potential disastrous consequences to our political as well as economic systems of the continuing economic deterioration of American agriculture. I now take this opportunity to convey that same impression to you, as a representative of the administration.

Visualize, if you will, the following scenarios that could develop if agriculture was not the strong sector that it historically has been.

Suppose agriculture was not providing our economy with a balance of payments net surplus of $29 billion as it did in 1981. Without that surplus, our overall international trade deficit would have been a dismal $60 billion. How would a payments deficit of that magnitude affect the strength of the dollar on the world financial markets? How would that lack of trade affect the demand for other goods and services otherwise purchased by the agriculture sector with trade surplus funds? What other indirect effects would be caused by a trade disruption?

Next, suppose food prices had not stabilized in 1981, caused in part by plummeting prices absorbed by farmers. How would our inflation fight have fared if food costs rose as fast as housing or energy costs?

Along this line of food costs facing consumers, suppose that American consumers did not devote 16 percent of their income to food purchases, as they do, but rather had to devote 20 or 30 percent such as consumers in Western Europe pay. Since food is a necessity, I would guess that families would have to divert the funds used to purchase other goods to the purchase of food. Look at the resources our economy has free to use in the provision of other goods and services because food is a bargain compared to what those in other nations pay.

To strike a sobering picture, if food purchased comprised 22 percent of income, instead of just 16 percent, and if other purchases remained constant, all of our Nation's personal savings would be eliminated. In that sense, the efficiency of America's farmers is providing the means for America's consumers "to have their cake and eat it, too" to live the style to which they've become accustomed and yet to set aside the savings required for capital investment needed to spark economic recovery.

In another light, just imagine how many millions of jobs would be lost in the growing, storing, transporting, processing, merchandizing, and marketing of food alone if the United States wasn't the leading and most efficient food growing nation in the world.

Finally, with so much talk about looming and enormous deficits, try to imagine a current year deficit $40 billion greater than any estimate you have heard. It has been reported that the Soviet Union provides its farmers $40 billion per year in subsidies. Imagine what stress would be placed on our economy and social structure if we had to absorb that kind of Government intervention.

Mr. Secretary, I have a responsibility to my State and to our country. I cannot let agriculture's needs pass unrecognized. Last night, our President barely mentioned agriculture, and then only in passing. The industry that flourished before the industrial revolution has kept pace with that revolution and has contributed more than its share in providing continuing growth in wealth and well-being. The current recession is not new to our agriculture sector. It never recovered from the one that started in 1980. It is my intention as a member of the Joint Economic Committee to cause my colleagues, in the Congress, the administration and the American people to recognize that agriculture makes a significant contribution to our economy at large. All people benefit through raised standards of living resulting from the productivity gains in agriculture. I hope that the scenarios just stated help to illustrate the contribution we have come to take for granted. We cannot let the world's finest agriculture system deteriorate, and I am determined to promote sound Government policy to this vital industry to survive and, hopefully, to prosper once again.

OPENING STATEMENT OF SENATOR HAWKINS

It is a pleasure to welcome you to these annual hearings. I must note, however, considerable concern over both the present size and the rate of increase in the national debt. In no small measure, this increase is fueled by high interest rates. For too many years, the Federal Government has fueled these high rates both by the magnitude and by the nature of its borrowing.

The Federal Government accounts for about one-third of all borrowing in the Nation's credit markets and this appears to be growing. As you know, the growing Federal share crowds out more productive borrowers.

Over the past 40 years, the "average maturity" of marketable public debt has decreased considerably. This, of course, forces the Treasury to go into credit markets more and more frequently. For example, in the immediate post World War II period the average maturity of Government marketable securities was 10½ years, it is now just over 4 years. The net effect is to add extra costs to the Treasury making it even more difficult to balance the budget.

Over the next few months Congress will be looking for alternative, less painful routes to lower interest rates and this is linked to fiscal responsibility. A 90-day freeze on off-budget borrowing has been suggested. And some in Congress are proposing windfall profits taxes on interest profits above the rate of inflation.

I am not enamored with any of these proposals, but they illustrate that there will be a lot of talk during the rest of this year as Congress scrambles for ways out of our economic troubles.

We must keep the long-run, "big picture" perspective. The economic recovery program will lead to lower interest rates as it solves our broader economic problems. The tax cuts, which have only just begun will begin to have real stimulative effect later this year. They are beginning to provide strong incentives for capital investment which in turn will put us back on the path of productivity growth rates of earlier years. Thank you.

Representative **Reuss**. Mr. Secretary, do you have a prepared statement?

Secretary **Regan**. I have a prepared statement, Mr. Chairman, and I do beg your pardon, but the copies of my detailed statement are not available at this moment. We are having them put together as quickly as possible. The reason is that I was waiting for the President to make his presentation last night, indeed I have been crafting some of my remarks based on his remarks earlier this morning, but they will be here during my period as a witness.

Representative **Reuss**. Fine. We certainly understand your time problem. We have the same problem. So just proceed in any way congenial.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary **Regan**. Fine. I do have the prepared statement now.

Mr. Chairman, I do appreciate this opportunity to appear before the Joint Economic Committee immediately following the President's state of the Union message. Last night the President presented this Nation with another dramatic blueprint for carrying out the evolutionary changes in Government that he has promised the American people. As we consider the Nation's economic situation this morning, we must keep in mind the strength, determination, and commitment demonstrated by the President last night. He said that the state of the Union and the economy will be better, much better, if we summon the strength to continue on the course we have charted. I cannot overstate the President's commitment to staying on this course, to maintaining the combination of economic measures he outlined a year ago, and to provide the leadership necessary to keep it on track. There can be no mistaking by the public, by the Congress, by business leaders or anybody else, the degree of certainty that President Reagan is instilling in this program.

Following the recovery from the 1974-75 recession, real GNP growth declined steadily, from increases of 5.5 percent year over year in 1977, 4.8 percent in 1978, and 3.2 percent in 1979 to a decrease of 0.2 percent in 1980. Contrary to the conventional wisdom that slower growth would reduce inflation, inflation worsened. The CPI rose 6.5 percent year over year in 1977, 7.7 percent in 1978, 11.3 percent in 1979, and 13.5 percent in 1980.

With higher inflation came higher interest rates. After averaging just over 5 percent in 1977, the 3-month Treasury bill rate tripled to over 15.5 percent by December 1980. The prime rate was 21.5 percent in December 1980, having exceeded 13 percent in 12 of the previous 16 months.

Productivity, measured year over year, fell from 1977 to 1980. This was reflected in wages. Real average hourly earnings were lower in 1980 than in 1971. Meanwhile, tax burdens generally were substantially higher, reducing take-home pay per worker even further.

During this period of general decline, the Government kept growing. Budget outlays rose from between 20 and 21 percent of GNP in the early 1970's to a postwar record of 23.1 percent in fiscal year 1981—nearly $1 in every $4 generated by our economy. Outlays soared nearly 200 percent during the decade of the 1970's.

The tax burden was rising as well. In spite of legislated tax reductions, the overall tax receipts of the Federal Government rose nearly $250 billion from fiscal year 1977 to fiscal year 1981, and still we accumulated deficits of almost $200 billion. In spite of tax reductions, personal income taxes as a percent of personal income rose from about 10 percent in 1975 to 11.5 percent by 1980 and had been projected to rise to over 15 percent by 1986 without any major tax reduction. If we take account of social security tax increases, the average tax rates rose from 12.7 percent to 14.5 percent during this period and would have increased to nearly 19 percent by 1986.

Average tax burdens do not tell the whole story, however. Because of the steeply progressive rate structure of the individual income tax, inflation forced taxpayers into higher marginal tax brackets even though average tax rates were occasionally and temporarily being reduced by a series of generally ineffective tax bills. This created serious problems for work incentives, saving, and investment. Personal savings rates fell from 8.6 percent of disposable income in 1975 to 5.6 percent in 1980 and bottomed out at a low 4.3 percent in the first quarter of 1981. In the labor markets, the rising marginal tax rates were impairing the competitive situation of U.S. labor in the world economy.

Businesses fared no better. Inflation increased their tax liabilities and distorted their saving and investment decisions, due chiefly to the fact that depreciation allowances were not adjusted for the rising cost of plant and equipment in computing taxable income. The rate of return on plant and equipment plummeted, reducing investment and productivity growth sharply.

Recognizing the shortrun costs and the longrun benefits of controlling inflation, the administration remains committed to its goal of slow and steady money growth over the long run. Given that goal, we supported money growth in the middle of the Federal Reserve's M1B target range in 1981, and we support money growth in the upper third of the Federal Reserve's tentative M_1 target range for 1982.

The erratic pattern of money growth that occurred in 1980 and in 1981 contributed to the onset of the current downturn. At various times during the year, we at Treasury have hinted, sometimes in private, sometimes in public, that we would like either faster or slower money growth. Some have accused us of being unable to make up our minds.

Well, nothing could be further from the truth. We have consistently urged faster money growth when the money supply was flat or declining, and slower money growth when the money supply was rising at double-digit rates. We supported the Federal Reserve's targets and consistently urged them to keep money growth even and steady within the target range.

The past 2 months provided a good example of the disruptive effects of volatile money growth. Since October, the rate of money growth has accelerated rapidly, following 6 months of near-zero growth. The rapid reacceleration of money growth has renewed concerns about inflation, renewed skepticism about monetary control in general, and created enormous uncertainty in the financial markets. The result has been a reversal of the dramatic decline in interest rates that had been underway since September. I hope that those who still believe that high interest rates are caused by a tight monetary policy have been paying attention.

A steady monetary policy is absolutely essential if we are to steady the financial markets and reduce interest rates. Stability of policy is the key requirement for any permanent recovery in output and employment.

The economy in early 1980 had been weakened by several factors. There had been 4 years of excessive money growth, rising inflation, rising interest rates, rising tax rates, and rising Federal spending as a share of GNP. Rates of return on investment and savings were severely depressed. The interest-sensitive sectors, such as autos and homebuilding, were already in a severe slump.

The second quarter of 1980 was one of sharp collapse, at a 9.9-percent annual rate. It was followed by two quarters of very slow recovery, with 2.4 and 3.8 percent growth. Not until the 8.6-percent growth of the first quarter of 1981 did real GNP exceed that of the first quarter of 1980.

Unfortunately, the 1981 recovery was soon choked off in what might best be described as a continuation of 1980 situation. Homebuilding and autos had never really recovered from the slump on the previous year. The basic causes of the 1980 downturn had never really been corrected. The causes were the same: Erratic money growth; continued high inflation and interest rates; and rising tax rates.

By the spring of 1981, autos, construction, and consumer durables were under renewed pressure, responding to the renewed upturn in interest rates. Real GNP fell 1.6 percent at an annual rate in the second quarter, although it recovered a bit in the third, rising at a 1.4-percent annual rate, before declining at a 5.2-percent rate in the fourth quarter.

The National Bureau of Economic Research has picked July as the peak month of the expansion, although the economy was clearly not healthy for several months prior to that point. One could just as easily characterize 1980 and 1981 as a single period of zero growth or recession.

This was the situation we inherited. Fortunately, we understand its causes and have put into place a four-part program to correct the errors of the past and to restore economic growth and full employment while reducing inflation.

With the help of the Congress, we achieved significant reduction in the growth of Federal spending for fiscal year 1982 and beyond.

An incentive tax policy is in place. The Economic Recovery Tax Act was signed into law in August 1981 with its major provisions taking effect over 5 calendar years.

Under the full 3-year incentive tax rate reduction, followed by indexing in 1985, bracket creep that has been poisoning labor negotiations and pricing U.S. labor out of world markets is at an end. The rising marginal tax rates that, with inflation, have cut personal savings rates in all brackets almost in half between 1975 and 1980 will be reduced.

The accelerated cost-recovery system shortens the period over which investments in plant and equipment may be recovered for tax purposes. For the first time in years, firms will be allowed a tax writeoff large enough to let them fully replace their plant and equipment, the costs of which have been rising sharply with inflation.

Regulatory reform is underway to reduce the inefficiencies and enormous costs that are holding back production and raising prices. It will be a labor of many years.

Monetary policy, although still unsteady, has shifted toward reducing inflation. Restraint was most noticeable beginning in May 1981. We have encouraged the Federal Reserve to keep money growth steady at levels consistent with a gradual return to stable prices and low interest rates.

The causes and the timing of the recession are obvious to any reasonable observer. The economy was peaking out and entering the recession months before the administration's economic program was in place. The spending reductions and tax changes were enacted after the recession began and will have their major impact in fiscal year 1982 and beyond.

There is no school of economic thought—Keynesian, monetarist, or supply side—which provides even the hint of a suggestion that any of the policies called for by the administration could have retroactively brought on this downturn. Indeed, spending restraint and tax incentives are widely recommended policies for encouraging growth and modernization of the private sector. Stability in monetary policy tends to reduce interest rates and inflationary expectations and is a necessary precondition for the saving and investment essential to growth. In fact, there is no other way to reduce interest rates on a permanent basis.

These policies are just beginning. It will take time for them to work. However, there are signs of progress already.

Consumer prices, which rose 12.4 percent during 1980, rose 8.9 percent in 1981.

Producer prices for finished goods, which rose 11.8 percent during 1980, rose only 7 percent in 1981 and indicate continued moderation at the consumer level in the months ahead.

Interest rates, driven by inflation to record highs in the last 2 years, have since fallen. The prime rate, 21.5 percent a year ago, is now at 15.75.

Manufacturers' durable-goods orders, an important leading indicator, have shown broad-based increases in the last 2 months. Housing starts are up. These are signs that the economy may be heading up by the second quarter.

We must continue to restrain the growth of Federal spending to enable the economy to grow out from under the spending burden. Whether financed by taxes or borrowing, Government spending absorbs physical and financial resources better used for private-sector growth.

While selected tax changes may be desirable to eliminate outmoded provisions in the tax law, care must be taken to preserve the saving and growth incentives embodied in the Economic Recovery Tax Act.

The basic cause of the currently projected deficits is not the tax cut. The basic cause of the projected deficit is the sluggish economic performance of 1980-81 and the continued rapid growth of Government spending in real terms. For each additional point of unemployment, the deficit is widened by about $25 billion, as revenues fall and outlays rise on income-maintenance programs.

In spite of all the tax changes we have enacted, the $3 trillion U.S. economy, if it were growing at 4 to 5 percent per year in real terms, would generate $30 to $35 billion in additional real tax revenues each year in 1981 dollars.

Spending reduction and economic growth are the only methods for balancing the budget while increasing employment, take-home pay, and living standards. On the other hand, without spending restraint and faster real economic growth, it is doubtful that we will ever see a balanced budget.

I understand the concerns of Congress and the financial markets over the deficit. Deficits do matter. They matter very much. They matter because of where they come from—excessive spending and inadequate real growth—and what they sometimes lead people to propose—massive, ill-designed tax increases or excessive, inflationary rates of money creation.

Excessive spending reduces growth by diverting real resources from those in the private sector who would use them to expand output and employment. Tax increases, particularly of the type which have been generated over the last decade by inflation, bracket creep, and underdepreciation, cripple the incentive to save, invest, and work. Taxes dip into personal savings and business retained earnings which might have gone into investment and growth, with even more undesirable disincentive side effects than Federal borrowing.

Inflationary money creation is equally to be feared. Under the threat of renewed inflation, savers will not take the risk of setting sufficient funds aside to finance the real growth and job creation we need. All deficits must be financed out of private savings.

I know, too, that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not surprising that some businessmen are holding back until they are certain it is safe to proceed.

Some investors expect, or at least hope for, a drop in interest rates, which are unusually high given the current relatively low rates of inflation. Others are simply nervous. They are made so in part by the erratic signals given off by the monetary statistics of late. But the most unsettling events are the repeated calls in certain quarters for drastic modifications in the business and personal tax incentives contained in the ERTA. This uncertainty is delaying the economic recovery. Those who have been burned repeatedly by frequent changes in Government policy may be forgiven for wondering if Washington can ever stick to a program long enough to make it work.

The President has recommended a number of initiatives for 1982 which will improve the performance of the economy and revitalize our urban centers.

Federalism has been a theme of President Reagan throughout his public career. He is committed wholeheartedly to returning authority, responsibility, and flexibility to State and local governments. When accepting the Republican nomination for President, he declared, "Everything that can be run more effectively by State and local government we shall turn over to State and local government, along with the funding sources to pay for it."

The first step toward transferring power back to the States was to move from categorical grants to block grants. We have made substantial progress in this area. Fifty-seven former categorical programs have been combined into nine new or modified block grants with budget authority over $7.5 billion.

The ultimate objective of this change, however, is to create a bridge leading to the time when State and local governments will have not only the responsibility for the programs that properly belong at the State and local level but the tax resources as well.

The New Federalism approach offers the advantage of greater administrative efficiency and the opportunity to encourage innovative solutions by local officials to meet the needs of their communities. As Federal mandates and restrictions are removed from programs that are transferred to State and local governments, significant administrative savings can be achieved because the cost of Federal overhead for planning, audit, and review—often duplicative and unnecessary—will be eliminated.

The transfer of power and responsibility, along with the funds, will permit government decisions to be made by local officials who can be held accountable for those decisions. This will result in greater diversity of services that will reflect more closely local needs and encourage more innovative and more efficient ways of providing these services at the lowest cost. Unquestionably, we can maximize efficiency and minimize costs by bringing government closer to its citizens and providing local officials the decisionmaking responsibility to chart their own futures.

At the same time, efficiency of Government will be strengthened if certain functions, now shared with State and local governments, are provided solely by the Federal Government. Programs that fall into this category are primarily those which involve little regional variation in cost and are more equitable and effective if they provide uniform benefits and eligibility criteria regardless of where the recipients live.

In light of these considerations, the President has proposed a dollar-for-dollar budget exchange of programs with the States and localities. Some 40 programs involving welfare, transportation, and education will become State and local responsibilities. States will assume full responsibility for AFDC, food stamps, and child-support enforcement by 1984. At the same time, the Federal Government will assume full responsibility for medicaid.

Funding for these transferred programs will be provided from an expanded trust fund administered by Treasury. The fund would contain moneys currently allocated to revenue sharing, community development block grants, and urban development block grants. To these would be added the revenues from current excise taxes and the windfall profit tax.

The administration will propose a slightly modified version of the package of tax changes which the President suggested last September. They are designed to remove a number of provisions of the tax code which are no longer warranted or which were made obsolete by the passage of the Economic Recovery Tax Act. In addition, several changes are recommended to improve compliance with provisions of current law and to insure that constructive provisions of the code do not lead to the unintended result of eliminating tax liability for companies which are not losing money.

The enterprise zone proposal represents an attempt to create jobs and redevelop blighted areas by promoting an environment that is conducive to new business ventures and the expansion of existing business activity. Although Federal, State, and local participation will be important to the success of the enterprise zone program, the driving force must come from private-sector initiatives. The role of the public sector will be more like that of a catalyst.

We are hopeful that the improved tax base from higher employment, income, and property values in the zones will more than compensate local governments for the services they provide. Most important, we are certain these economic gains will improve the incomes and job prospects of those now residing in these disadvantaged areas.

[The prepared statement of Secretary Regan follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

Mr. Chairman and Members of the Committee:

As we embark on the second year of this Administration, it is helpful to examine where we have been, where we are now and where we are going. This before and after picture will illustrate clearly, I believe, the progress--modest but positive-- we have made in trimming down an overgrown Federal government, curbing the excesses of past policies, and setting the stage for a decade of noninflationary growth.

First, let us examine the legacy of stop and go fiscal policies, erratic monetary policy, rapid inflation and rising interest rates, declining productivity and a weakening real economy that was left to this Administration when we arrived one year ago. Not only were all the major economic trends unfavorable, but traditional approaches to these problems seemed incapable of pinpointing the source of the problem or of finding a solution.

Years of Declining Performance

Following the recovery from the 1974-1975 recession, real GNP growth declined steadily, from increases of 5.5 percent year over year in 1977, 4.8 percent in 1978, and 3.2 percent in 1979 to a decrease of 0.2 percent in 1980. Contrary to the conventional wisdom that slower growth would reduce inflation, inflation worsened. The CPI rose 6.5 percent year over year in 1977, 7.7 percent in 1978, 11.3 percent in 1979, and 13.5 percent in 1980.

With higher inflation came higher interest rates. After averaging just over 5 percent in 1977, the 3-month Treasury bill rate tripled to over 15.5 percent by December of 1980, having spent 11 of the previous 16 months in double digit territory. The prime rate was 21.5 percent in December of 1980, having exceeded 13 percent in 12 of the previous 16 months.

Productivity, measured year over year, fell from 1977 to 1980. This was reflected in wages. Even after allowing for overtime and shifts of jobs among industries, real average hourly earnings were lower in 1980 than in 1971! Meanwhile, tax burdens generally were substantially higher, reducing take-home pay per worker even further.

Inherited Fiscal Policy

During this period of general decline, the government kept growing. This was not a new development. Through Fiscal Year 1981, government spending had risen by an average of 12 percent per year during the decade. Budget outlays rose from between 20 and 21 percent of GNP in the early 1970's to a postwar record of 23.1 percent in Fiscal Year 1981--nearly one dollar in every four generated by our economy. Outlays soared nearly 200 percent during the decade of the seventies.

The tax burden was rising as well. In spite of legislated tax reductions the overall tax receipts of the Federal government rose nearly $250 billion from FY 1977 to FY 1981 and still we accumulated deficits of almost $200 billion. In spite of tax reductions, personal income taxes as a percent of personal income rose from about 10 percent in 1975 to 11.5 percent by 1980 and had been projected to rise to over 15 percent by 1986 without any major tax reduction. If we take account of social security tax increases, the average tax rates rose from 12.7 percent to 14.5 percent during this period and would have increased to nearly 19 percent by 1986.

Average tax burdens do not tell the whole story, however. Because of the steeply progressive rate structure of the individual income tax, inflation forced taxpayers into higher marginal tax brackets even though average tax rates were occasionally and temporarily being reduced by a series of generally ineffective tax bills. This created serious problems for work incentives, saving and investment. Personal savings rates fell from 8.6 percent of disposable income in 1975 to 5.6 percent in 1980, and bottomed out at a low 4.3 percent in the first quarter of 1981. In the labor markets, the rising marginal tax rates were impairing the competitive situation of U.S. labor in the world economy. The rising rates gave further impetus to the shift away from straight wage increases into non-taxable fringe benefits, shorter hours and more days off with pay.

Businesses fared no better. Inflation increased their tax liabilities and distorted their saving and investment decisions due chiefly to the fact that depreciation allowances were not adjusted for the rising cost of plant and equipment in computing taxable income. The rate of return on plant and equipment plummeted, reducing investment and productivity growth sharply.

Monetary Policy

The President's original economic program included the recommendation that money growth be gradually reduced to a non-inflationary pace. During the past year, the Federal Reserve made significant progress toward that goal.

Fourth quarter to fourth quarter, M1B grew slightly less than 5 percent in 1981. Compared to the inflationary rates of monetary expansion in the past--7.3 percent in 1980 and an annual average of 8.0 percent in the preceding three years--this is a substantial deceleration in money growth. The Federal Reserve's tentative target ranges for 1982, 2-1/2 to 5-1/2 percent for M1, represent continued progress toward noninflationary money growth and the Administration fully supports that general policy.

The Administration's original recommendation was that the rate of money growth gradually be cut in half by 1984 from the average 7.8 percent rate of the prior four years; this is the assumption that we built into our economic projections. The deceleration that has actually occurred has been much more rapid--we have gotten almost three-fourths of the planned reduction in the first year.

This more rapid deceleration of money growth has economic consequences--some good, some bad. It is leading to a faster reduction in inflation, but it also means that the associated restrictive effect on nominal GNP and incomes reduces growth in Federal revenues ahead of growth in Federal spending, thus contributing to higher budget deficits. It is amply clear from history, both here and abroad, that deficits, if not monetized, do not produce inflation. Indeed, the lower rate of inflation is a partial cause of the current deficit.

Recognizing the short-run costs and the long-run benefits of controlling inflation, the Administration remains committed to its goal of slow and steady money growth over the long run. Given that goal, we supported money growth in the middle of the Federal Reserve's M1B target range in 1981, and we support money growth in the upper third of the Federal Reserve's tentative M1 target range for 1982.

The erratic pattern of money growth that occurred in 1980 and in 1981 and which contributed to the onset of the current downturn. At various times during the year, we at Treasury have hinted, sometimes in private, sometimes in public, that we would like either faster or slower money growth. Some have accused us of being unable to make up our minds.

Nothing could be further from the truth. We have consistently urged faster money growth when the money supply was flat or declining, and slower money growth when the money supply was rising at double digit rates. We supported the Federal Reserve's targets, and consistently urged them to keep money growth even and steady within the target range.

In the last three months of 1980, M1B fell at an annual rate of one percent per year, after a sharp rise in the previous five months. Virtually all of the growth in M1B in 1981 occurred in the first four months of the year, when it grew at a 13.3 percent annual rate, and the last two months of the year, when M1B growth was at a 13.0 percent rate. In the interim, M1B oscillated from week to week. In the six months from April to October, the net change was a decrease of 0.1 percent. Such volatile money growth has very damaging effects on the economy. It destroys the credibility of long-run monetary controls, adds to uncertainty and risk, and thereby helps keep interest rates high as lenders seek to protect their principal.

This very erratic pattern has kept financial markets in a state of disarray for some time. During 1981, there appeared to be a particularly close relationship between variability in monetary growth and short-term rates. Acceleration in monetary growth was associated with sharp increases in short-term rates, while deceleration in monetary growth was associated with declines in short-term interest rates. This is an important lesson. Faster money growth causes interest rates to go up, not down.

The past two months provided a good example of the disruptive effects of volatile money growth. Since October, the rate of money growth has accelerated rapidly, following six months of near-zero growth. The rapid reacceleration of money growth has renewed concerns about inflation, renewed skepticism about monetary control in general, and created enormous uncertainty in the financial markets. The result has been a reversal of the dramatic decline in interest rates that had been under way since September. I hope that those who still believe that high interest rates are caused by a "tight" monetary policy have been paying attention.

For these reasons, the Administration would like to see a moderate rate of money growth, in the upper third of the Fed's new target range, achieved in a steady and consistent pattern. While precise money control over short periods of time cannot realistically be expected, the extreme fluctuations experienced in recent years could and should be dampened. In fact, a steady monetary policy is absolutely essential if we are to steady the financial markets and reduce interest rates. Stability of policy is the key requirement for any permanent recovery in output and employment.

The 1980 and 1981 Downturns

The economy in early 1980 had been weakened by several factors. There had been four years of excessive money growth, rising inflation, rising interest rates, rising tax rates, and rising Federal spending as a share of GNP. Rates of return on investment and savings were severly depressed. The interest-sensitive sectors, such as autos and homebuilding, were already in a severe slump.

The economy badly needed a period of moderate and steady monetary expansion. Instead, 1980 and 1981 witnessed some of the most pronounced swings in the monthly and quarterly growth rates of the money supply in history. These swings contributed to sharp movements in interest rates, mostly upward, and helped to spread the weakness in the initially depressed sectors throughout the economy.

The second quarter of 1980 was one of sharp collapse, at a 9.9 percent annual rate. It was followed by two quarters of very slow recovery, with 2.4 and 3.8 percent growth. Not until the 8.6 percent growth of the first quarter of 1981 did real GNP exceed that of the first quarter of 1980.

Unfortunately, the 1981 recovery was soon choked off in what might best be described as a continuation of the 1980 situation. Homebuilding and autos had never really recovered from the slump of the previous year. The basic causes of the 1980 downturn had never really been corrected. The causes were the same: erratic money growth, continued high inflation and interest rates, and rising tax rates.

By the spring of 1981, autos, construction and consumer durables were under renewed pressure, responding to the renewed upturn in interest rates, which were driven back to near-record levels by the upsurge in money growth from February to April. Real GNP fell 1.6 percent at an annual rate in the second quarter, although it recovered a bit in the third, rising at a 1.4 percent annual rate, before declining at a 5.2 percent rate in the fourth quarter. Industrial production showed very little growth from March to July. It peaked in July and fell rapidly thereafter through the end of the year. The National Bureau of Economic Research has picked July as the peak month of the expansion, although the economy was clearly not healthy for several months prior to that point. One could just as easily characterize 1980 and 1981 as a single period of zero growth or recession. Real GNP (seasonally adjusted annual rate) in the third quarter of 1981 was only 0.4 percent greater than that in the first quarter of 1980; the preliminary estimate for the fourth quarter of 1981 is for real GNP 0.4 percent less than in the 1st quarter of 1980.

What we have been through is an extended period of very poor and erratic economic performance. It has been characterized by erratic money growth, uncertainty in the financial markets, sharp increases in interest rates and pronounced distress in housing, autos and consumer durables. What is needed is a clear resolution of monetary policy to provide a strong base for recovery of these industries and a strong expansion of the entire economy.

Economic Recovery Program

This was the situation we inherited. Fortunately, we understand its causes, and have put into place a four-part program to correct the errors of the past, and to restore economic growth and full employment while reducing inflation.

- With the help of the Congress, we achieved significant reduction in the growth of Federal spending for Fiscal Years 1982 and beyond. The spending reductions already enacted and those still to be proposed cut the rate of growth of spending roughly in half and will bring spending down to about 22 percent of GNP by 1983. Further spending reductions, coupled with faster economic growth, will bring us closer to our long-term goal of 19 to 20 percent of GNP in the years ahead.

  This is not an ideological goal. It is a necessary step to return the real and financial resources now being absorbed by the government to the private sector, where they can be used for investment and growth.

- An incentive tax policy is in place. The Economic Recovery Tax Act was signed into law in August 1981 with its major provisions taking effect over five calendar years. This is not a random tax cut to give away money, only to have the government borrow it back. It is a carefully structured tax cut designed to raise the rewards to each additional hour worked and each additional dollar saved, to encourage people to supply more effort, more saving and more investment to the economy.

Under the full three-year incentive tax rate reduction, followed by indexing in 1985, bracket creep that has been poisoning labor negotiations and pricing U.S. labor out of world markets is at an end. The rising marginal tax rates that, with inflation, have cut personal savings rates in all brackets almost in half between 1975 and 1980, will be reduced. Discriminatory tax rates on income from saving have been ended.

The accelerated cost recovery system shortens the period over which investments in business property may be recovered for tax purposes and simplifies this cost recovery computation compared to the prior depreciation system. Along with the increases in the investment tax credit, it will restore a reasonable rate of return on investment in plant and equipment. For the first time in years, firms will be allowed a tax write-off large enough to let them fully replace their plant and equipment, the costs of which have been rising sharply with inflation.

- Regulatory reform is under way to reduce the inefficiencies and enormous costs that are holding back production and raising prices. It will be a labor of many years.

- Monetary policy, although still unsteady, has shifted toward reducing inflation. Restraint was most noticeable beginning in May of 1981. We have encouraged the Federal Reserve to keep money growth steady at levels consistent with a gradual return to stable prices and low interest rates.

The causes and the timing of the recession are obvious to any reasonable observer. The economy was peaking out and entering the recession months before the Administration's economic program was in place. The spending reductions and tax changes were enacted after the recession began, and will have their major impact in Fiscal Year 1982 and beyond. There is no school of economic thought--Keynesian, monetarist, or supply side--which provides even the hint of a suggestion that any of the policies called for by the Administration could have retroactively brought on this downturn. Indeed, spending restraint and tax incentives are widely recommended policies for encouraging growth and modernization of the private sector. Stability in monetary policy tends to reduce interest rates and inflationary expectations and is a necessary precondition for the saving and investment essential to growth. If fact, there is no other way to reduce interest rates on a permanent basis.

These policies are just beginning. It will take time for them to work. However, there are signs of progress already.

- Consumer prices, which rose 12.4 percent during 1980, rose 8.9 percent in 1981.
- Producer prices for finished goods, which rose 11.8 percent during 1980, rose only 7.0 percent in 1981, and indicate continued moderation at the consumer level in the months ahead.
- Interest rates, driven by inflation to record highs in the last two years, have since fallen. The prime rate, 21-1/2 percent a year ago, is now at 15.75.
- Manufacturers' durable goods orders, an important leading indicator, have shown broad-based increases in the last two months. Housing starts are up. These are signs that the economy may be heading up by the second quarter.

To be frank, we had initially hoped to do better. We had hoped to bring interest rates down last spring instead of this fall, and to avoid an outright recession. Unfortunately, the economy could not ~~hold~~ out under the accumulating burdens of past policies beyond the first quarter of 1981 to give us time to act.

In addition, our program was subjected to a number of revisions and delays in implementation.

We had hoped for about $160 billion in spending reductions over the period through 1984 in round one of the Administration's spending cuts. We got about $30 billion less. We had hoped to bring spending down to about 19 percent of GNP by 1984. Spending restraint and faster economic growth will gring us part way toward that goal, but it will take a few years longer than originally planned.

We had hoped for a 30 percent personal tax rate reduction starting July 1st at 10 percent a year for three years. We got a bit under 25 percent, on average, with the first installment reduced to 5 percent and delayed until October 1st of last year. That amounts to only 1.25 percent for tax year 1981. In fact, bracket creep and social security tax increases produced roughly a $15 billion tax increase for 1981 in spite of the 5 percent cut. The net personal tax rate reduction for calendar year 1982 will be only 10 percent instead of 20 percent, and will be roughly offset in dollar terms by bracket creep and social security increases. Only in 1983 and 1984 will the majority of families experience real savings. We have prevented major tax increases. We have not had major tax cuts.

We had hoped for a steady money growth rate in 1981. Instead, the uneven 1981 pattern of money growth, following an erratic and unsettling money supply pattern in 1980, kept financial markets in a state of disarray. Interest rates fell early in the year, rose to near-record levels again in the spring as money growth accelerated, remained high in the summer, and did not decline substantially until fall as money growth and inflationary expectations slowed over several months.

The Task Remaining

We must continue to restrain the growth of Federal spending to enable the economy to grow out from under the spending burden. Whether financed by taxes or borrowing, government spending absorbs physical and financial resources better used for private sector growth. Manpower, finished goods and raw materials consumed by government are urgently needed to expand and modernize the private sector. More of the real output of the private sector must be left to those who produce it, to reward workers and savers for their efforts.

While selected tax changes may be desirable to eliminate outmoded provisions in the tax law, care must be taken to preserve the saving and growth incentives embodied in the Economic Recovery Tax Act. Higher levels of private sector saving, over $250 billion more in 1984 than last year will finance government and private sector borrowing needs without inflationary money creation by the Federal Reserve. Renewed economic growth at sustainable rates, spurred by the investment and work incentives, will yield substantial revenue gains from current levels and, by reducing unemployment and poverty, will relieve pressures on the Federal budget for safety net spending.

The basic cause of the currently projected deficits is not the tax cut, which, on the personal side, is not a net tax cut for some years to come. The basic cause of the projected deficit is the sluggish economic performance of 1980-1981 and the continued rapid growth of government spending in real terms. For each additional point of unemployment, the deficit is widened by about $25 billion as revenues fall and outlays rise on income maintenance programs.

Economic growth is the single best means of narrowing deficits. In spite of all the tax changes we have enacted, the $3 trillion U.S. economy, if it were growing at four to five percent per year in real terms, would generate $30 to $35 billion in additional real tax revenues each year in 1981 dollars. If we had projected a scenario holding Federal spending constant in real terms, which itself would facilitate economic growth, and allowed for the growth induced by the Economic Recovery Tax Act, we could have projected the elimination of our remaining deficits by 1985. However, even under the second round of spending proposals we will be submitting to the Congress, there will be continued real growth of the Federal budget. This will delay achieving the budget balance for a bit longer, and serves as a reminder that more work is needed to bring Federal spending under control.

Spending reduction and economic growth are the only methods for balancing the budget while increasing employment, take-home pay and living standards. On the other hand, without spending restraint and faster real economic growth, it is doubtful that we will ever see a balanced budget.

I understand the concerns of Congress and the financial markets over the deficit. Deficits do matter. They matter very much. They matter because of where they come from--excessive spending and inadequate real growth--and what they sometimes lead people to propose--massive, ill-designed tax increases or excessive, inflationary rates of money creation.

Excessive spending reduces growth by diverting real resources from those in the private sector who would use them to expand output and employment. Tax increases, particularly of the type which have been generated over the last decade by inflation, bracket creep and underdepreciation, cripple the incentive to save, invest and work. Taxes dip into personal savings and business retained earnings which might have gone into investment and growth, with even more undesirable disincentive side effects than Federal borrowing. Inflationary money creation is equally to be feared. Under the threat of renewed inflation, savers will not take the risk of setting sufficient funds aside to finance the real growth and job creation we need.

All deficits must be financed out of private savings. We are confident that the saving of households and businesses over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation. Normal year-to-year increases in saving run $40 to $50 billion each year. Adding a conservative estimate of the personal savings and additional business retained earnings induced by the ERTA brings the increase in saving over 1981 levels to about $60 billion in 1982 and over $250 billion in 1984.

I know, too, that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not surprising that some businessmen are holding back until they are certain it is safe to proceed.

Some investors expect, or at least hope for a drop in interest rates, which are unusually high given the current relatively low rates of inflation. Others are simply nervous. They are made so in part by the erratic signals given off by the monetary statistics of late. But the most unsettling events are the repeated calls in certain quarters for drastic modifications in the business and personal tax incentives contained in the ERTA. This uncertainty is delaying the economic recovery. Those who have been burned repeatedly by frequent changes in government policy may be forgiven for wondering if Washington can ever stick to a program long enough to make it work.

What the economy needs is a respite from the burden of excessive spending growth. If given time to grow out from under the spending burden, the economy can perform wonders. Pressure for inflationary money growth, and talk of delaying the savings, investment and work incentives in the ERTA, would be part of the problem, not part of the solution. The best thing we can do for the economy is to get behind the President's program and see it through.

With your help, and the help of the millions of American workers, savers, and enterpreneurs across the country, we can, and we will, achieve the twin economic goals of this Administration--stable prices and prosperity for all.

Initiatives for 1982

The President has recommended a number of initiatives for 1982 which will improve the performance of the economy and revitalize our urban centers.

The New Federalism

Federalism has been a theme of President Reagan throughout his public career. He is committed wholeheartedly to returning authority, responsibility, and flexibility to State and local governments. When accepting the Republican nomination for President, he declared "everything that can be run more effectively by State and local government we shall turn over to State and local government, along with the funding sources to pay for it."

The first step toward transferring power back to the States was to move from categorical grants to block grants. We have made substantial progress in this area. Fifty-seven former categorical programs have been combined into nine new or modified block grants with budget authority over $7.5 billion.

The ultimate objective of this change, however, is to create a bridge leading to the time when State and local governments will have not only the responsibility for the programs that properly belong at the State and local level but the tax resources as well.

The new Federalism approach offers the advantage of greater administrative efficiency and the opportunity to encourage innovative solutions by local officials to meet the needs of their communities. As Federal mandates and restrictions are removed from programs that are transferred to State and local governments, significant administrative savings can be achieved because the cost of Federal overhead for planning, audit and review--often duplicative and unnecessary--will be eliminated. The transfer of power and responsibility, along with the funds, will permit government decisions to be made by local officials who can be held accountable for those decisions. This will result in greater diversity of services that will reflect more closely local needs and encourage more innovative and more efficient ways of providing these services at the lowest cost. Unquestionably, we can maximize efficiency and minimize costs by bringing government closer to its citizens and providing local officials the decision making responsibility to chart their own futures.

At the same time, efficiency of government will be strengthened if certain functions, now shared with State and local governments, are provided solely by the Federal Government. Programs that fall into this category are primarily those which involve little regional variation in cost and are more equitable and effective if they provide uniform benefits and eligibility criteria regardless of where the recipients live.

In light of these considerations, the President has proposed a dollar-for-dollar budget exchange of programs with the States and localities. Some 40 programs involving welfare, transportation and education will become State and local responsibilities. States will assume full responsibility for AFDC, food stamps and child support enforcement by 1984. At the same time, the Federal government will assume full responsibility for Medicaid.

Funding for these transferred programs will be provided from an expanded trust fund administered by Treasury. The fund would contain monies currently allocated to Revenue Sharing, Community Development Block Grants and Urban Development Block Grants. To these would be added the revenues from current excise taxes and the windfall profits tax.

The trust fund and the States' savings on Medicaid would more than make up for the cost of the assumed programs during the initial phase of the transfer, 1984-1987. Over the next three years, all Federal excise taxes would expire, with the States free to pick them up as a new revenue source, or to take other tax or budget action with regard to the programs.

Tax Initiatives

The Administration will propose a slightly modified version of the package of tax changes which the President suggested last September. They are designed to remove a number of provisions of the tax code which are no longer warranted or which were made obsolete by the passage of the Economic Recovery Tax Act. In addition, several changes are recommended to improve compliance with provisions of current law and to ensure that constructive provisions of the code do not lead to the unintended result of eliminating tax liability for companies which are not losing money.

Administration Enterprise Zone Proposal

The Enterprise Zone proposal represents an attempt to create jobs and redevelop blighted areas by promoting an environment that is conducive to new business ventures and the expansion of existing business activity. Although Federal, State and local participation will be important to the success of the Enterprise Zone program, the driving force must come from private sector initiatives. The role of the public sector will be more like that of a catalyst.

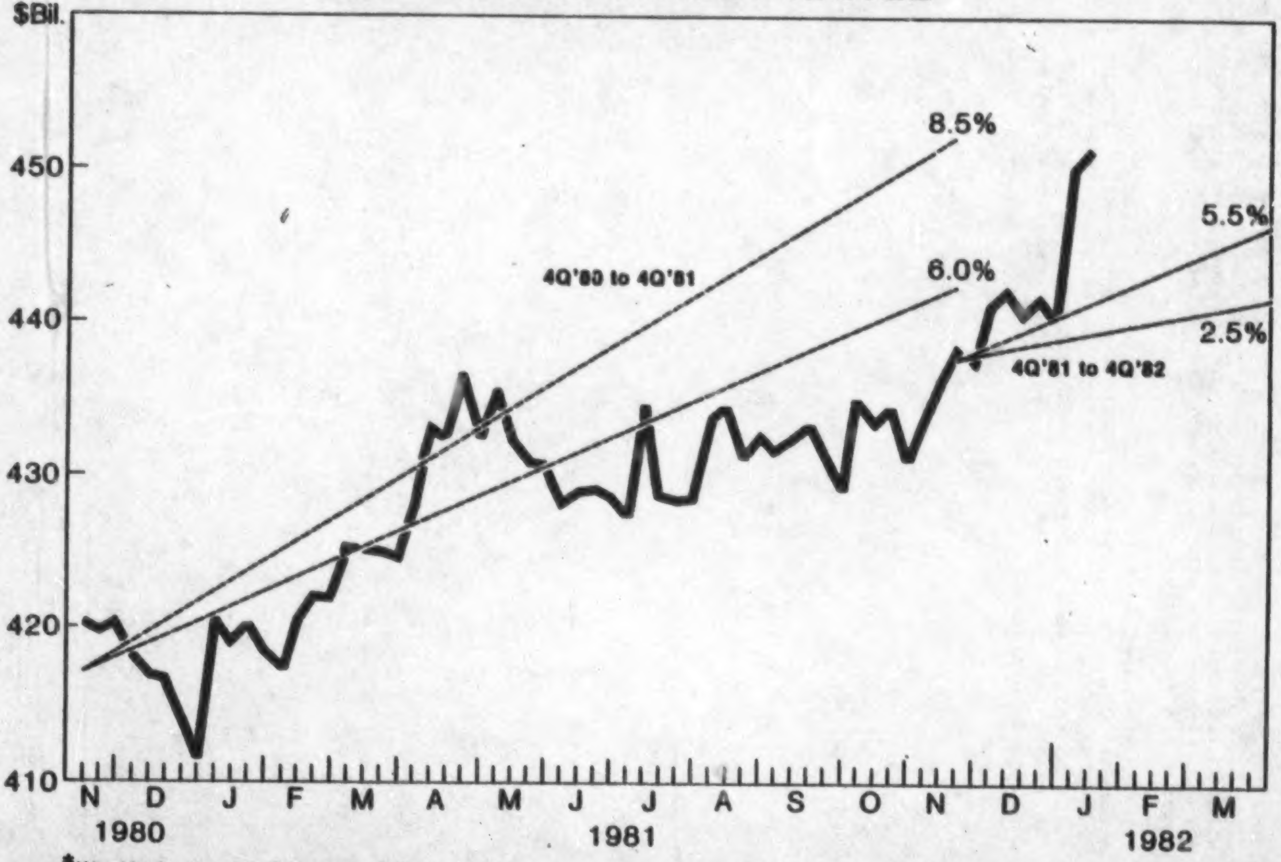
The Enterprise Zone program provides tax incentives and relaxes government regulatory barriers to encourage economic growth in designated Zones. The purpose of the incentives is to help overcome the extraordinary conditions and costs (e.g., crime and insurance costs, lack of skilled labor, inadequate infrastructure and government services) that discourage the location of economic activity in distressed areas; encourage the creation of jobs for economically disadvantaged workers; and encourage other workers to seek employment in these Zones.

The Federal income tax credits are designed to lower the costs of labor and capital used in the Zones. Labor and capital are the two principal productive inputs; these credits are an efficient way to lower the cost of producing goods ~~and services~~ in what would otherwise be high cost areas.

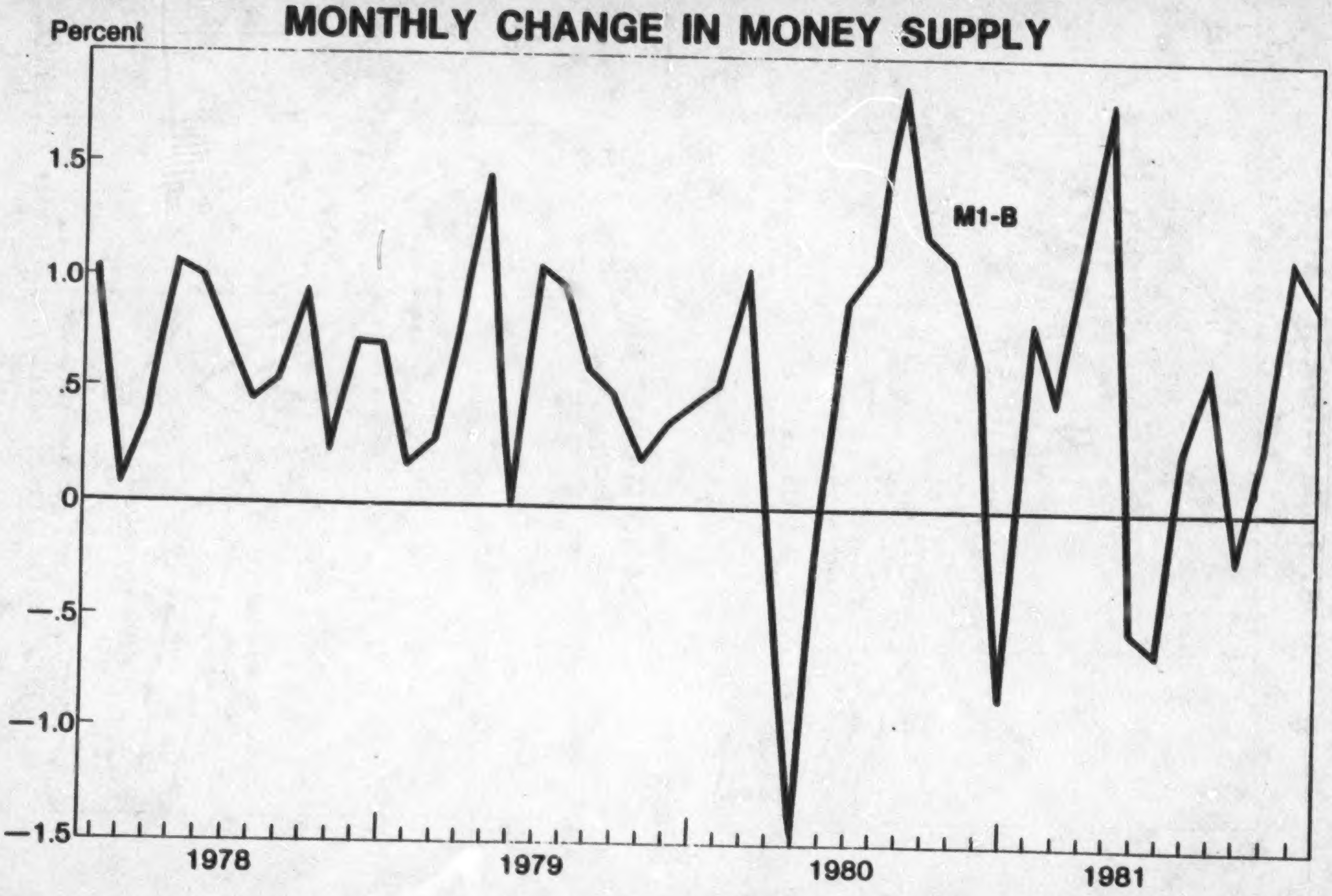
States and localities will be encouraged to add to the Federal tax and regulatory relief efforts with incentives of their own. In particular, we hope that there will be a concerted effort to improve city services and infrastructure in the Zones. We also hope for local planning assistance which might encourage a few major developers, manufacturers or small business groups to consider entering the Zones simultaneously. The neighborhood costs of a depressed environment, which might be too much for a single pioneering firm to bear, can be lowered dramatically if many properties are rehabilitated at once, and many businesses enter the area together.

We are hopeful that the improved tax base from higher employment, income and property values in the Zones will more than compensate local governments for the services they provide. Most important, we are certain these economic gains will improve the incomes and job prospects of those now residing in these disadvantaged areas.

M_1 VERSUS TARGET RANGE*



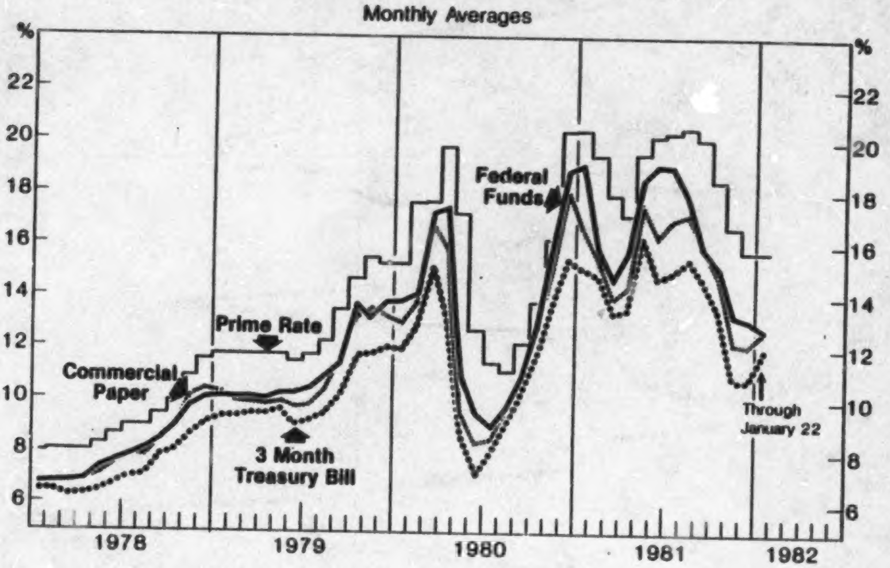
*Weekly Averages - Seasonally Adjusted



MONTHLY CHANGE IN MONEY SUPPLY

SHORT TERM INTEREST RATES

Monthly Averages

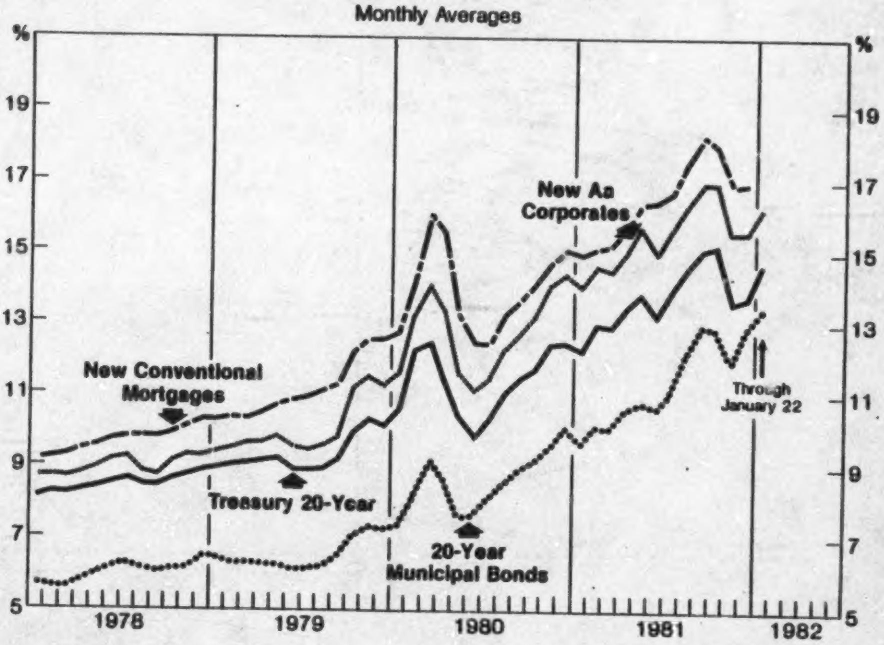


Office of the Secretary of the Treasury
Office of Government Financing

January 26, 1982-6

LONG MARKET RATES

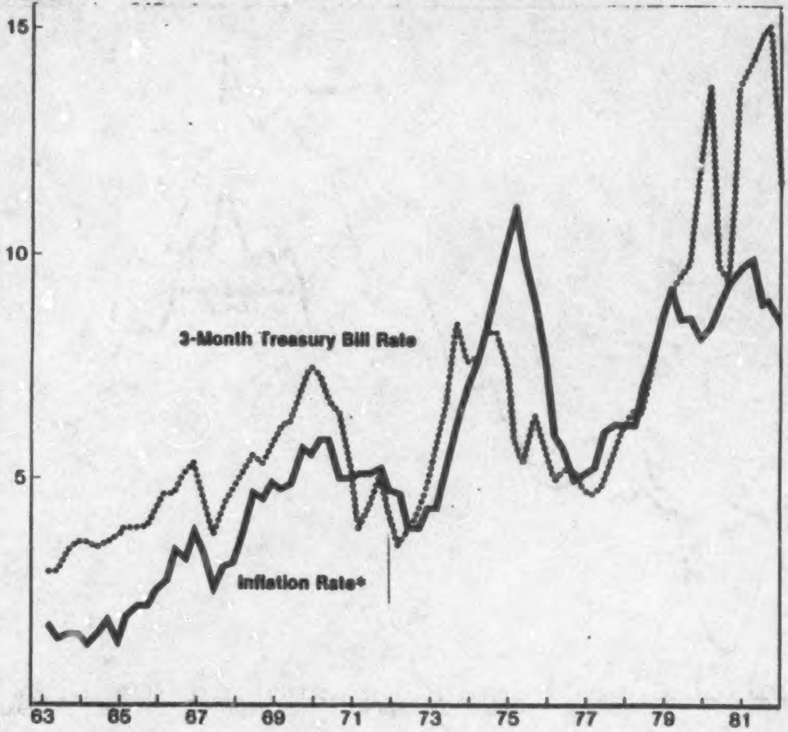
Monthly Averages



Office of the Secretary of the Treasury
Office of Government Financing

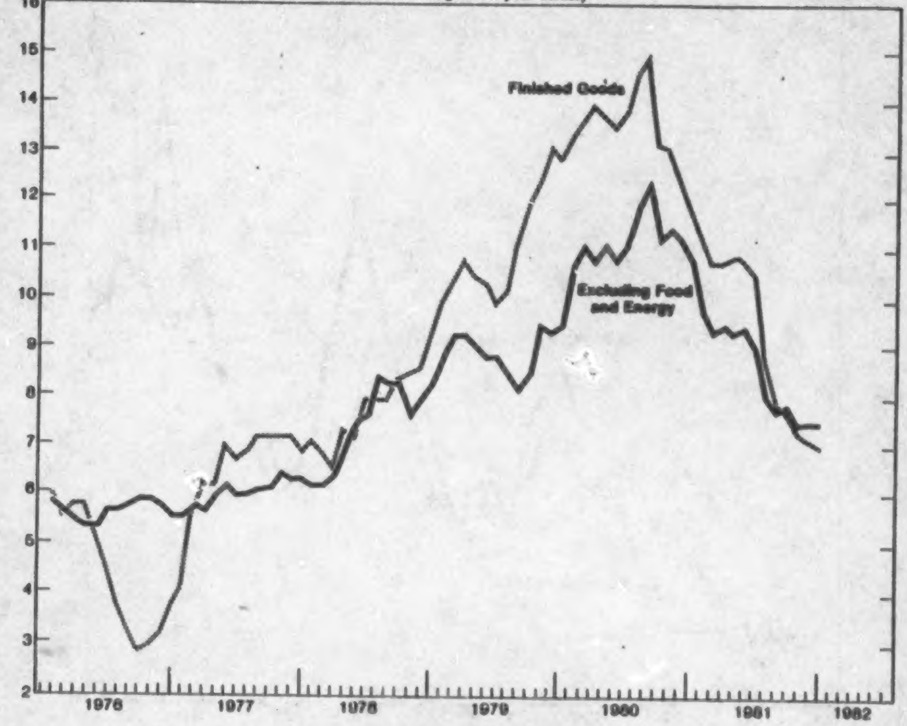
January 26, 1982-6

INTEREST RATES AND INFLATION



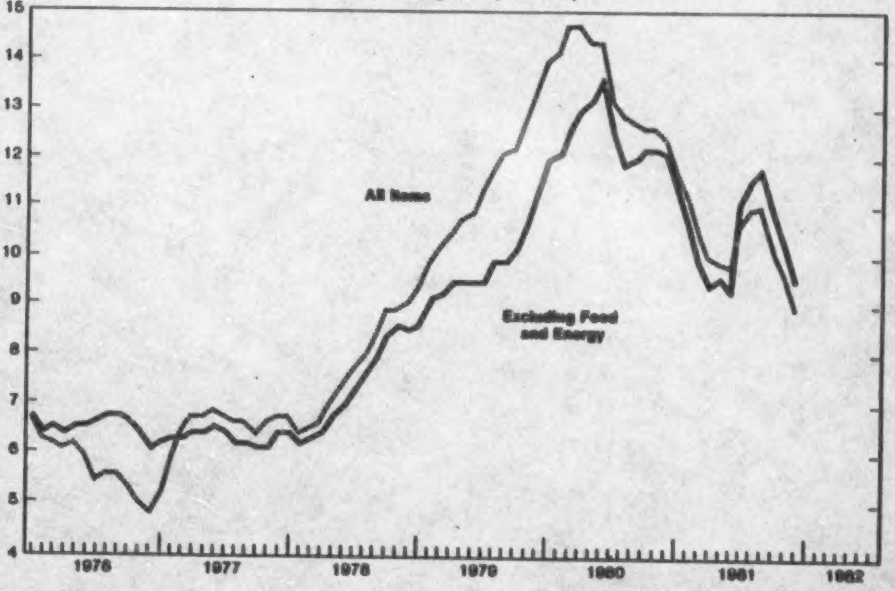
* Growth from year earlier in GNP deflator.
Plotted quarterly.

January 27, 1982 A100



Producer Prices

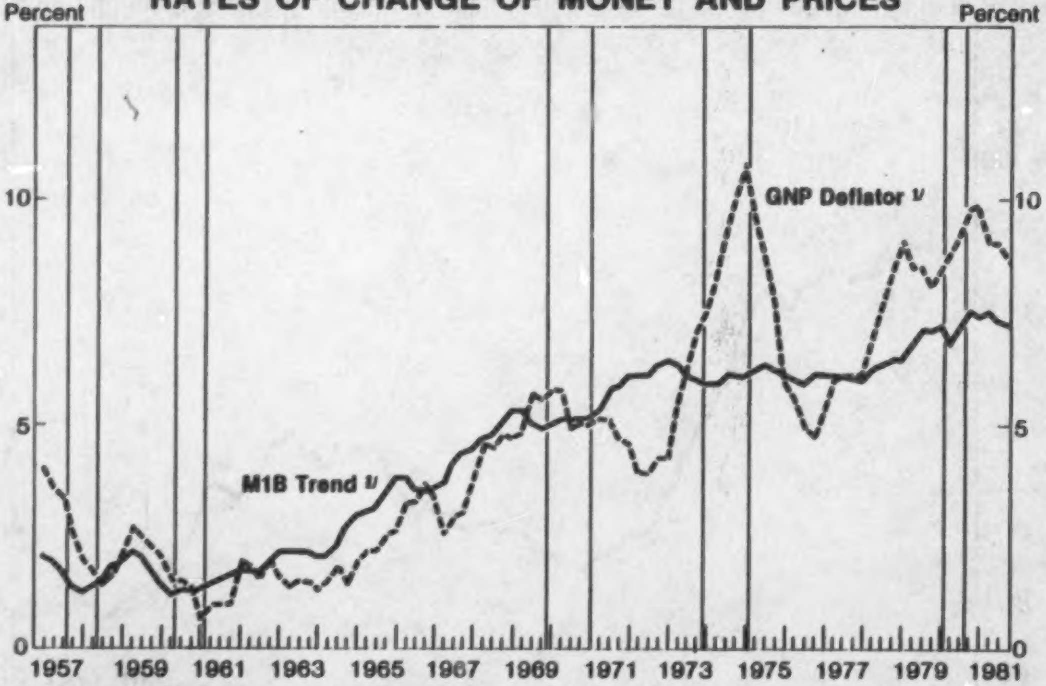
(percent change from year earlier)



Consumer Prices

(percent change from year earlier)

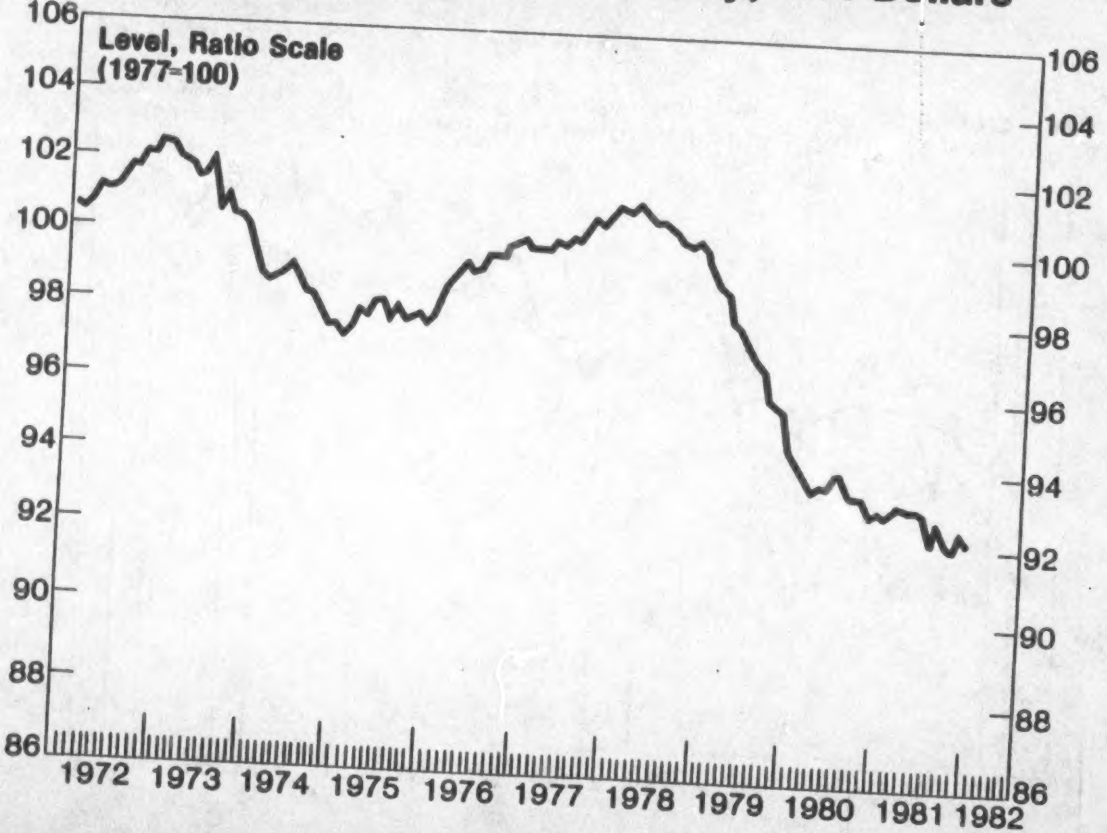
RATES OF CHANGE OF MONEY AND PRICES



1/ Four-quarter rate of change;
2/ Twenty-quarter rate of change; data prior to 1st quarter 1964 are M1.
Latest data plotted: 4th quarter

January 27, 1982 A184

Real Average Hourly Earnings Index
Total Private Nonfarm Economy, 1977 Dollars



Representative REUSS. Thank you very much, Mr. Secretary.

You have said—and this is very important because the administration views on monetary policy have a deep effect on markets—that you favor a rate of growth of M_1, the most common monetary aggregate, for 1982 of between 4.5 and 5.5 percent. Do I have you right?

Secretary REGAN. That's right. We said the upper third of the Fed's area.

Representative REUSS. The answer to my next question is obviously no but I'll ask it anyway. You do not then favor a rate of growth of M_1 for 1982 of 2.5 to 3.5 percent?

Secretary REGAN. No; we do not.

Representative REUSS. That's too low?

Secretary REGAN. That is too low.

Representative REUSS. And that would produce, if someone were so unwise as to attempt it, an undue slack in the economy, increased deficits, and added misery, would it not?

Secretary REGAN. It would not allow the economy to recover with the rapidity which we think it should.

Representative REUSS. Well, in view of your position, for which I commend you, won't you join me in urging the Federal Open Market Committee at its meeting next Tuesday not to lower the target for 1982 so that it would make possible a 2.5- to 3.5-percent M_1 monetary aggregate growth increase?

Secretary REGAN. Well, Mr. Chairman——

Representative REUSS. It seems to me if we let them do that, that which they target, they might feel a weapon ready at hand to use, and if, as you say—and again, I agree with you—that during frequent times in the recent past their monetary targeting has been too low, why encourage them to go and do it worse in 1982 when we have a recession?

Secretary REGAN. Well, they obviously select their targets from a band and the band—the target area, if you will, in 1982 is 1.5 to 5.5. The idea of the band, of course, being that their instruments are a little on the blunt side and if they are not precise in what they have been able to do they obviously have to correct. They don't want to overcorrect, so they give themselves a bottom and a top. And what we are urging is that they stay in that range, hopefully in the upper third of the range.

Now what has happened here, they are starting out from a very high base because money supply in the month of January following November and December has shot up dramatically, so much so that there's been a lot of concern in the marketplace about its rapid rise. Were they to try to correct for that and overcorrect, this indeed would be unfortunate because that would be a repetition of 1980 and 1981 which again is what they did. In the first part of the year the money supply was up and they overcorrected and then we got no growth for 6 months. So what we are trying to do is tell them to be a little more steady at the helm and avoid this lurching that they are doing.

Representative REUSS. Well, I'm antilurching too, but if as you say—and it's so true—that in the month of January 1982 M_1 has gotten out of hand on the top side—it's been something like 13 percent and has got a lot of people worried—why should you and I sit back and let the Fed make their task of correction more difficult by pushing their targets down? Why, in heaven's name, don't they keep their target at the 1981 level of 3.5 percent to 6 percent which would enable you to get your 4.5 to 5.5 percent ideal without their scraping the top?

Secretary REGAN. Well, that's a matter of definition, Mr. Chairman. I think what the Fed is trying to do and something that we would support them in is gradually, over a period of years, bring that money growth down from where it had been in the 6-, 7-, and 8-percent annual range.

Representative REUSS. Yes; but at that point you pointed out in your prepared statement that it had been a whale of a year for target reduction. You say—and again, you're absolutely right—you say the administration's recommendation was that the rate of money growth be cut in half by 1984 from the average 7.8 percent rate of the prior 4 years. The deceleration that has actually occurred has been much more rapid. We've gotten almost three-fourths of the planned reduction in 1981.

If that's true, and it is true, why in heaven's name in the teeth of a recession, with 9.5 unemployed and business bankruptcies at a harrowing rate, should you and I encourage the Fed to adopt a target range which has in it a built-in incentive for them to goof off again? Why do we do this?

Secretary REGAN. Well, as you know, all we in the administration do is to urge them to do something. We obviously don't have the power to dictate.

Representative REUSS. I realize that, but if you say that you're going to sit still for a 2.5- to 5.5-percent range and they come in with another miserable 2.5 percent, you can't criticize them. You've told them to do that. Why don't you be in a position where you can criticize them for creating what you have just testified would be a disastrously low rate of M_1 increase; namely, 2.5 to 3.5 percent?

Secretary REGAN. Well, what we have suggested to them is they try to stay in the upper third of that band. That's the place we want them to be and we don't want to be in the position to criticize them; we would rather be in a position to applaud them for being there. I think they get the point well enough to know that in a recessionary period that they cannot come in with that low rate of growth.

Now the only reason that I'm hesitating at all, Mr. Chairman, is that I'm thinking ahead. Remember, we're talking here about the entire year of 1982, not just the first quarter or even indeed the second quarter. Were we by the fourth quarter to be in that very happy place where the economy is recovering very rapidly, we wouldn't want the money supply then to overheat. So that's why I'm a little bit hesitant as to be saying to them never hit 2.5.

Representative REUSS. Let me recall to you a nice little built-in feature of these targets and I know quite a bit about them because we helped develop them. The targeting legislation says that if things change drastically, change the target. So if you reach such a Nirvana where you wanted really to squeeze the money supply to repell a boiling monetary inflation, we, the Congress, will go right along with you in requesting the Fed to do that.

But let me get back to my point. The Open Market Committee meets next Tuesday. Many of us have let them know how we feel. I think it would be very helpful if you let them know right now how you feel and, quite honestly, as we sit here today on January 27, and in the light of your testimony, I don't see how you can advise the Open Market Committee to put themselves in this iron maiden of 2.5 to 3.5 percent monetary growth. Why permit them to do something, encourage them to do something which you just testified would be a disaster?

Secretary **Regan**. Well, I think that the Fed, knowing what has happened to money in the month of January, the Federal Open Market Committee will be very sensitive to the fact that while we want to reduce the money from the 13-percent greater growth that we'll have in the month of January, that obviously they want to bring it down, but they shouldn't jam on the brakes and bring it to no growth. I think if we continue to tell them to stay in the upper part of the band that that will suffice to give the direction.

I don't think I would want to have the Treasury Department, or indeed the administration, giving directions as to the absolute band that the Fed should be using. I think that sets a bad precedent.

Representative **Reuss**. Well, I admire your sensitivity, but it seems rather "Pickwickian." If you don't mind telling them to hit that 4.5 to 5.5 but adopt a band that will produce a disaster, why don't you join me right now in the general expression, not binding on the independent autonomous Federal Reserve, that the Treasury believes that a 4.5- to 5.5-percent particularized target would be fine, and that the band consistent with that precise target of 3.5 to 6 percent which is what it was in 1981 will suit you just fine and won't cause you to blow a fuse at all next Tuesday when you hear it? Would you join me in that honest statement?

Secretary **Regan**. I would like to join you, Mr. Chairman, but I think perhaps my sensitivities would rather have me—I will join the first part of your statement, that we think 4.5 to 5.5 percent, and if they desire to change the band or if they would change the band to accommodate that, that would not be inimical to us. I wouldn't want to put precise figures on it.

Representative **Reuss**. I think I'll yield to Congressman Brown.

Representative **Brown**. Mr. Secretary, I would change the subject for just a minute, but I want to come back to this effort at developing a consensus here because we may have some agreement between the three of us, which in itself would be startling and scare the hell out of a lot of people.

The President said last night that he was going ahead with the enterprise zone program on an experimental basis. Could you outline how that program will proceed and what specifically will be offered to the businesses that locate in the zones?

The reason I ask that question is that I've followed for the last few years—and I hope you're familiar with—the Warren-Sherman area in Toledo, Ohio. That's a depressed area just next to the downtown section of Toledo with 33 percent unemployment. The entire community—the government, the banks, the churches, the large and small businesses and community groups—have all joined together to try to turn around. They have achieved some sound success through their efforts, but those people in Toledo will be the first to tell you I think that recognition as an enterprise zone would bring in the second and third level of investment that that community needs and spinoff investment that would have a dramatic effect upon the rest of the city.

So, Mr. Secretary, could you outline for us how the enterprise zone program will proceed. Would you think that efforts like Warren-Sherman, which have made a substantial effort on their own, should seriously be considered for that kind of designation or will there be entirely new zones set up?

Secretary REGAN. First of all, Mr. Brown, let me say we at Treasury are reasonably familiar with the Toledo situation. We know of the efforts there. We have studied that as part of our study of what is going on in enterprise zones currently throughout the country. So I can assure you that that is one of the areas which will be under active consideration when these zones are set up.

Briefly, enabling legislation will probably be sent up to the Congress after the February recess, sometime in the March area or sooner if it can be reached.

What we are trying to do is to have the enterprise zone concept up as quickly as possible so that Members of Congress can focus on it. It's not a cure-all by any stretch of the imagination for nationwide unemployment and should not be regarded in that way, but indeed what we think it is, it's a targeted type of program designed not only for urban areas but for small towns and for rural areas as well that are in this blighted situation where they are losing businesses, losing people, general decay has set in and nobody knows how to get it out of this way.

The tax code will be revised to give tax incentives to those who will move into these areas with businesses or indeed who are there with businesses now and will expand them. We think that this is the logical way to go, to give them investment tax credits over and above the normal tax credits for hiring the disadvantaged in those zones, for staying in those zones, giving them relief from let's say capital gains as an example for transactions of selling their property within those zones.

We have asked the cooperation of the local, State, and other municipalities in relief again from taxes in those zones to give the incentives to have people move in the type of jobs that can be used there, labor intensive type of jobs rather than warehousing or things of that nature. So what we probably will do will be to pick out 25 or so localities as experiments to start the program and then to continue with those over a period of the next several years adding 25 each year to make certain we don't jump into a massive program and stub our toe on something that doesn't work, find out what our areas—see what the good points are, hear from the people themselves about our concept and how it can be put into practice.

Now, as I suggested in my prepared statement, we are indeed going to need the cooperation of the private sector and, as you have said, in Toledo the private sector there is heavily involved in what's going on. We cannot go there and make jobs ourselves. There's no way the Government can put a factory in. There's no way the Government can start manufacturing. The Government can act as a catalyst, though, with tax incentives and other types of incentives to make the thing work if the private initiative is there.

Representative **Brown**. That program in Toledo has been broadly based within the community not defined to a narrow area. It would be my hope that it will be broadly based and that broad base will be encouraged by the legislation, but it will not get broadly based as say the economic development grants have in the past to the point where every place in the country winds up as an enterprise zone. It seems to me that may frustrate the program. I hope that you do keep it fairly limited and experimental and I hope you can also build on such places as Warren-Sherman where they have already got a pretty good start purely from local initiative, as you point out.

Secretary **Regan**. That's our intention right now.

Representative **Brown**. I thank you for that aside, Mr. Secretary.

Let me go back to our discussion about what's happened to the growth of M_1. Our statistics differ slightly because I took M_1 and not M_{1B} with this chart, but you and the chairman were in a dialog about how it would be nice if we could hit proper targets. I have to suggest that the supply side economics and the President have called for a monetary policy that gradually and consistently reduces the growth rate of the money supply. Some argue that the Fed's tight money policy of last year was just what supply-side economics was asking for, just what you were asking for. I think you have articulated that very well in your testimony, that literally you did change your advice from one thing to another as the money growth or the monetary system began to spike, and it was not very consistent in retrospect.

This line shows the average of the first 4 months, as you point out, of 13 percent. Then for the May–October average, the 6 months in the middle of the year which induced the situation we're into now, it was down to less than 1 percent growth. Now it's up there somewhere around 17 percent based on November, December, and January figures.

The question I have is, is it possible at all for the Fed really to have the kind of control over the monetary system, the money supply, that we expect them to have? With all that spiking, it doesn't seem to me they have very much control. It doesn't even seem to me they have very much control on moving average. It might be desirable to keep it within a 1-percent band, 4.5 to 5.5 percent, as the chairman says, or I think he said it might even find 3.5 percent to 6.5 percent desirable, but for goodness sake, that seems to me to be a jump from somewhere down here at minus 7 percent up to 27 percent. That's about a 35-percent band.

Is it really possible for the Fed to control the monetary system in any rational way or is there some advice that you could give to the Fed on how they might do it better?

Secretary **Regan**. Well, I'm speaking now, Congressman Brown, from the point of view of a practicing financier rather than one who's a theoretical economist, also one who has never been on the Federal Open Market Committee.

Representative **Brown**. I think we are all in that boat, so go right ahead.

Secretary **Regan**. So offering advice may be gratuitous here, but nonetheless, I do think they can have more precise controls. I do think that is achievable. I recognize it's a difficult task, but there are few things in life that are worth achieving that aren't difficult to get and I think that the Fed can work to come up with more precise targets. They did change their procedure, as you know, in October 1979 and started concentrating on these monetary aggregates. In that 27- or 28-month period so far, they don't seem to be able to be very precise about what they are doing. But there are suggestions, suggestions made by the Shadow Open Market Committee and other monetarists, of things that they themselves have put out for comment on contemporary accounting and things of that nature that they think perhaps might make them more precise getting figures.

It seems to me in these days of electronic funds transfer and the huge computers we have we should be able to be more precise about the supply of money in the United States than we were in bygone eras.

I also notice, of course, our economy is much larger than that of most of our trading partners, but even while erratic, the German, British, and Swiss central banks seem to be able to control their money supply fairly well.

So I do think that the Fed could be more precise. I know they are working toward that and we at Treasury have offered to work with them in anything that they think they want to try to see if we can eliminate some of those spikes.

Representative **Brown**. Well, my time is up. I want to come back and ask you questions on this subject, but before I yield the time entirely, let me ask if we aren't better critics in retrospect than we are in advance? It occurs to me that there's got to be some way, some specific way, that you can anticipate the psychology of the borrowing community a little bit better than we have in the past so that better control can be kept on the situation. I think the Fed may be somewhat overestimated in its ability and perhaps even in its capacity to do that job.

Secretary **Regan**. Well, without getting too arcane in our discussion here, Congressman Brown, a lot depends upon what happens at the desk of the Fed in New York in translating the wishes of the Federal Open Market Committee into actual practice, where they have to step into the market with repo's or reverse repo's and at what time of day and what time of the week and things of that nature that they actually step in to do something. Today's Wednesday. Everybody knows that Wednesday is settlement day and things fluctuate, particularly in Federal funds, very widely on a Wednesday. It's a question of what do they do in a period of that nature? If they're trying to withdraw reserves from the market, just how much of a repo's is needed in order to get reserves out of that market permanently or how much do they need to inject in it? I think this is where more concentration on the actual mechanics might indicate a little more subtlety and a little more precision could be used.

Representative **Brown**. Without scratching any old wounds, it seems to me when Mobil buys Marathon—or maybe I should say United States Steel buys Marathon or DuPont buys Conoco—somebody creates an awful lot of money in that debt obligation and that that may have some effect on things, too.

Secretary REGAN. Well, there are two sides to that. It depends upon how that money is spent, because when they raise that money they pay the money to somebody. The money stays within the system. It depends upon how much new money is created there in the process.

Representative BROWN. Thank you, Mr. Chairman.

Representative REUSS. Representative Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Secretary, you are by far the most experienced, competent, and successful businessman in the President's administration. I've watched your progress for many years and respected the job you have done in New York City.

Now for you to come here and make these statements—I know basically you're an excellent businessman and have a good grasp of the American economy—it just boggles my mind. You have made no reference whatsoever to the $100 billion deficit that's hanging over us this year, none to the $400 billion deficit which will be the result of this present administration. You haven't indicated what this deficit is going to do to inflation, to interest rates, to continuing the recession. Then you have blithely made the statement that during the second quarter of this year the economy will improve and I thought perhaps in the next few minutes we might examine some of these things.

First of all, why do you say the economy is going to improve in the second quarter? I can tell you, as a stockholder in a company that makes secondary products for major companies, that the second quarter of this year will not improve. The reason it won't improve is that housing starts will stay down because nobody, but nobody, can afford 17 percent for a housing mortgage. So your biggest ability to turn around a recession, as you know, is housing because once you have a house, you buy carpets and you buy furniture and you buy appliances and you buy all manner of consumer goods and without a house you don't bother buying those things.

Now with interest rates at 17 percent on a mortgage, there are very few people in the United States that can afford to buy a house. At the convention in Las Vegas, the National Housing Association themselves indicated that they thought there would be 750,000 starts this year. I don't call that much of an improvement.

Now we go to automobiles. Here again, you have very high financing rates. You've got a turbulent situation in the automotive industry where the average American still isn't sure that the cars that are being made now are the cars he or she wants and an individual is really not very anxious to buy a car unless his present car just falls apart. Also, we note that the automotive companies are teetering on the brink of bankruptcy. General Motors is in poor shape. Ford is in terrible shape and Chrysler is under water.

Then we go to the agricultural equipment area and farming, which as you know has been the mainstay of the economy of the United States these last few years, and nobody has given the farmers any credit for the fact that without the farmers we would be dead broke in this country.

Now here you have the farmers laboring under the worst commodity prices in modern history. If you indexed the price of corn, wheat, and soybeans today to back to the Great Depression, I guarantee you that corn, wheat, and soybeans were selling for higher prices in the 1930's than they are today.

Now where are the farmers going to get money to buy farm equipment? They're not. Which means International Harvester is going to go broke.

With all of our major industries teetering on the brink of bankruptcy, for you to say there's going to be recovery in the second quarter is totally "un-understandable." You don't show us how interest rates are going to come down and you know without lower interest rates we can't have a recovery. You don't show us what we're going to do toward reducing this $100 billion deficit or how maybe we can quickly stop some of the tax loopholes. Maybe we can think of that "Share the Burden" budget which I discuss with your Department day after day after day and start people who use Government services to pay for their own government services. And yet you say you're going to have a recovery.

Now you know better. I've got great respect for you and the excellent people around you.

Secretary **Regan**. All right, Congressman Richmond. Let's talk about it for a while.

First of all, for once in a recession the Congress and the administration have a program in place to take us out of a recession. We have the tax cuts that were passed last July and signed last August. They are already in place for business. Individuals have gotten a slight break on taxes in the fall of 1981. A few got more of a break January 1, with the marriage deduction penalty and a lot more are starting to save through IRA accounts which came in on January 1. On July 1, there will be another tax cut people can look forward to. So we have in place a recovery program to bring us out of the current recession.

Now what we need to do to come out, in order to encourage investment and the like, which you quite properly decry, we need a higher savings rate in the United States. We need to get more savings so that they are available so that the deficits that we have will not crowd out too much of the private sector and their need for funds in order to expand.

So how do we go about getting that? Well, first of all, the savings rate in 1982 will be much higher than the savings rate in 1981 and 1980 or 1979. Why? Because, first of all, the business portion of total savings is already in place. It's automatic through the accelerated capital recovery system for business. Whether business does a thing about it, they will get more money as a result of the accelerated capital recovery system.

Representative **Richmond**. Just to interrupt you a second, Mr. Secretary, if business is going to get more money, why are machine tools orders down 50 percent for the month of December and 30 percent for the entire year? There is leadtime when you order a machine tool. You have to expect it takes 6 months to a year before you get that machine tool. If every business were so sure we're going to come out of this recession and there will be plenty of money around, why wouldn't they be buying machine tools now?

Secretary **Regan**. We'll come to that in a minute. In order to get—the individual savings rate has started up at a 6-percent rate in the final quarter of 1981 with indications with the IRA accounts and the Keough accounts in place for 1982 that this savings rate not only should continue at 6 percent but should literally increase above 6 percent.

Now the year over year increase in savings usually runs $50 or $60 billion per year. With this added inducement of the tax cuts, plus the incentives to save, we are anticipating that we will get at least $60 billion and probably more this year in savings. By 1984, we are estimating between the capital recovery system of ACRS, plus the added savings of individuals, that will be brought about by the tax incentives, that we will have better than $200 and maybe even closer to $250 billion of additional savings by that time.

Now when this pool of savings comes in—it starts in 1982, the recession year, it does better in 1983, and better in 1984—the resulting deficits that we have will be accommodated. Now there will not be that crowding out phenomenon that most people are thinking is going to happen.

In addition, there is no evidence that huge deficits as a percent of GNP are inflationary or cause high rates of interest. All you have got to do is look at history, the most recent history of 1974, 1975, and 1976. There you had a recovery period. You had inflation coming down. You had interest rates coming down. That is exactly the type of situation that we think we will be in over the next few months and over the next year or two of a period of recovery.

So from the point of view of having interest rates come down, this will be the inducement for your housing market, for your automobile buyers. These things are a fact. Very definitely in the housing market, you know this better than I, that once you get interest rates below 14 percent that's when people in the housing business can start making money. There is an unusual premium in interest rates right now. That premium is a volatility premium as well as an inflation premium. It has been brought about the last several years by the exact thing we were talking about to Congressman Brown and the chairman, the volatility of the money supply.

Representative **Richmond**. And the fact that the Treasury is constantly in the market auctioning off its bonds.

Secretary **Regan**. It's not so much the Treasury is in the market auctioning off its bonds as much as it is to what is happening in the money supply, and people are not confident they know what's happening in the money supply. As a result, there's a volatility premium in interest rates as traders are burned in the street and they lose money. Pick up the newspaper day after day and you see our international corporations telling about lower earnings. Why? Because of differences in the money markets and what's happened in them.

Representative **Richmond**. Mr. Secretary, how come the administration and the President and everybody made a policy of a balanced budget just a year ago and we were all told the only way to save the United States was a balanced budget. Now suddenly we find his budget unbalanced. The President refuses to take even the slightest move toward balancing the budget. The President refuses to take the slightest move in the form of excise taxes which the general public approves of, as you know from the latest Gallup Poll, or closing the business tax loopholes. He mentioned closing the business tax loopholes. He didn't tell us how or where or what, but you and I know there are billions of dollars of business tax loopholes that ought to be closed.

Secretary **Regan**. Well, Congressman Richmond, first of all, the President is making no effort to close these budget deficits and make the budget balance. What the President is doing is trying to cut spending as much as possible.

Representative **Richmond**. On the backs of poor people, not on the backs of everybody.

Secretary **Regan**. No, I must say to you that lots of the things we have done are not on the backs of poor people.

What we have done in cutting social programs is cut out some of the waste in them and some of the people they were not intended for when the Congress first started these programs. What we are doing is cutting the size of those. We are not cutting them out. We are cutting them back and that's part of the federalism project to give them back to the States so the States themselves can have better control over these and the size of them.

Now coming to where you were as far as the business loopholes and the like, after all, the President's time was limited last night in his delivery to the Congress. We couldn't make everything specific. We are prepared at Treasury today to talk about those specific adjustments to the business tax code and, on the record this afternoon at a press conference, I am fully prepared to answer any questions that the press or others may have as to what specific things we intend to do.

Representative **Richmond**. Thank you, Mr. Secretary.

Representative **Reuss**. Senator Abdnor.

Senator **Abdnor**. Thank you, Mr. Chairman.

Mr. Secretary, I certainly welcome you to the committee today. I would just like to say that I thought it was an excellent presentation and speech by the President last night and I generally go along with what he's trying to do. I think I should tell you, though, that I was very disappointed in the fact that agriculture hardly was mentioned. I just heard something about family farms in one sentence last night and that disturbs me.

Congressman Brown was talking about the enterprise zone and that's good and we need something like that, but when I think of where agriculture seems to stand not only in this administration but in past administrations, it somewhat bothers me. I know over the years when I see grain sales are made to other countries whoever puts out that article is quick to say that this shouldn't cause food prices to go up, and I just submit to you that if we don't give some consideration to that end of it this country could be in big trouble in the agricultural sector.

Let me point out to you—and I shouldn't have to point out to you—a scenario—where would we be in this economic picture if we didn't come up with a $29 billion surplus in foreign agriculture trade? What would our balance of trade be? What would the picture be if the people of this country had to put in as large a percent of their take-home pay into food as they do in other countries? We say 16 percent. If you knock out the liquor or the booze part and the cigarettes, all you're really talking about is a little over 13 percent. This wasn't accomplished without sacrifice because farm expenses keep going up.

I would just like to point out to you that the total assets in agriculture—in agriculture alone—amounts to almost $1 trillion, which is almost the same as the $1.1 trillion in assets that all major manufacturing interests possess collectively. That's a big item. The farmers today have an indebtedness of something like, $200 billion. If you had interest rates down to 10 percent—and we would all hail that—if it was down to 10 percent, they would still be paying $20 billion in interest and their net income last year was something like $23 or $24 billion, and this bothers me because I think sometimes you have to look at this in a different picture than other sectors of the economy.

You say we've got to become more productive and we've got to expand. Well, I submit to you that agriculture productivity is the prize star of this country. It's gone up something like 70 percent since the 1950's. No other industry in this country has. And yet to me it seems like we are trying to hold inflation down at the expense of agriculture.

Do you see anything wrong with somehow, someway figuring how to make farming pay—and is it wrong to have farm prices go up some so they too could keep up with the economy?

Secretary **Regan**. Well, first of all, Senator, I'm sure that the President meant no slight to agriculture. Again, last night the exigencies and the necessities of time required that he concentrate on certain subjects within his talk.

Senator **Abdnor**. I realize that.

Secretary **Regan**. As a matter of fact, the very things that you're talking about were a subject of a Cabinet council on economics last week, worrying about these high interest rates and what they are doing to the family farms. Secretary Block put on an elaborate exposition of exactly what is happening here. This is one thing we cannot afford to lose. As you say, it's the mainstay of our foreign trade, the export of our agricultural products, and we desperately need that not only to feed ourselves but others. We are very sensitive to this.

What I'm saying, as I said in answer to the other gentleman's question, the whole idea here is to get interest rates down as quickly as possible. That's what we're trying to get this slow, steady growth in the money supply for. The money supply affects inflation. As inflation comes down, interest rates have to come down, and we have to have the confidence of our people that this will remain in a stable condition. As that happens, interest rates will come down. But as long as people are unsure about monetary policy, we are not going to get our interest rates down.

Senator **Abdnor**. Well, I'll agree with that and certainly it has been inflation and interest rates that have put the farmer behind the eight ball and in the mess that he's in, but I just recited to you an example of what 10 percent was going to do. That isn't going to be enough to really help the farmer, a 10-percent rate of interest on what they borrow, in relation to their income, won't do it, and that's the thing that bothers me. I certainly have supported the whole Reagan program—your accelerated depreciation, less regulation, investment tax credit. But by golly, they've got to have something to accelerate or deduct or take a credit on to make this recovery program work. I can see it in manufacturing.

As a matter of fact, I'll tell you one thing--we were talking about the International Harvester. If the farmers had a little income, we would take up the International Harvester in a hurry, but they have just had to quit buying. But more than that, they've got a great net worth. This inflation of farm land has been wonderful in that respect. Their land has gone up two or three times in 10 years or so. There's only one thing wrong. They don't have any cash flow. They've got to eat too, while they're getting rich. They say out my way, you live in poverty and you die rich, and I guess that's what it comes to.

Secretary **Regan**. That is something we're working with the Agriculture Department on, to see what types of creative financing we can come up with, to see whether there's any way to translate that equity.

Senator **Abdnor**. Financing is fine, but if they don't start figuring out some way to get some prices up—a good example—I know I'm off the subject a bit on this, but it's my chance to talk to you about it and make sure you carry it back to the Cabinet discussions, and I hail and commend Secretary Block for what he's doing. He's doing a great job of fighting for the farmer, but if they don't have some prices—sometimes financing is the worst thing you can do for them. They've got to have increased prices instead of a decrease. Corn is a good example. In a year's time it's down 7 cents a bushel. One thing we've got to do is—I know this farm bill was probably the most foreign trade oriented bill we've ever passed and we've got to get rid of some of those barriers and if we're going to go that route it's got to be done because we want them producing. I've got nothing else to say today. I just hope I helped express the entire situation of agriculture today.

Secretary **Regan**. I understand, Senator, and I will carry the message back.

Representative **Reuss**. Thank you. Senator Proxmire.

Senator **Proxmire**. Mr. Secretary, welcome. I'm delighted to see you.

Secretary **Regan**. Thank you.

Senator **Proxmire**. Mr. Secretary, I'm very concerned, as I think many of us are, about the size of the deficit and the expectation that it's going to continue at record high rates over the next several years. What I perceive here—and I want to come to that in a minute—what I perceive here is an indication that you recognize that you're not going to be able to balance the budget for years to come, probably not in this administration, at least not by 1985, and not until after that according to what you say in your prepared statement. But I'm also concerned because it seems to me that the deficit and the prospect that we are going to continue to expand the enormous national debt we have with the Federal Government borrowing these huge sums is the fundamental reason why interest rates are high and why they refuse to come down in spite of the fact that inflation is moderating.

Now it's easy to unload on the Federal Reserve. That's always been something that Congress has done ever since 1913 and it's fun to point out that you've got these so-called fluctuations. The fact is that Chairman Volcker appeared before this committee yesterday and he, I thought, made a very strong case that nobody was able to challenge—nobody—that from October 1979 until 1982 we have had a steady reduction in the rate of increase in the supply of money—and I say steady. Oh, week to week it goes up. Sometimes for a month it will go up. But as he pointed out, every quarter it has been at a reasonably slow rate, slower than it's been before and lower than the rate of increase in the cost of living or in most other indexes.

If you were Chairman of the Federal Reserve or any of us were Chairman of the Federal Reserve Board, what can you do when you face this colossal Federal debt, when you face these enormous deficits? That's why, Mr. Secretary, I'm concerned about the statement you make when you say:

> Economic growth is the single best means of narrowing deficits. In spite of all the tax changes we have enacted, the $3 trillion U.S. economy, if it were growing at four to five percent per year in real terms, would generate $30 to $35 billion.

Then you go on to say:

> If we had projected a scenario holding federal spending constant in real terms, which itself would facilitate economic growth, and allowed for the growth induced by the Economic Recovery Tax Act, we could have projected the elimination of our remaining deficits by 1985.

Now we're throwing in the sponge until 1985. President Reagan indicated first he might balance the budget in 1982, probably in 1983, and then 1984 was a solemn agreement. Now you say here, by what you say the implication is clear, we're not going to balance the budget in 1985.

Now I just wonder, in view of the fact that you won't balance it even if you get the kind of growth in the economy that you would like to get, what prospects do we have for seeing a sharp reduction in the deficit and a balanced budget within the next 2 or 3 years?

Secretary **Regan**. Well, I would have to say that what's happened here in our Balanced Budget Act was the onslaught of this recession earlier and deeper than we had forecast. We had not—and I don't know anybody else—who had forecast a year ago that there would have been such a severe recession in the final quarter of 1981. None of the leading econometricians, none of the leading forecasters, and even the consensus of the blue chip forecasted had this.

Now it has come in a lot more severe than we like. We're starting from a lower base. We've got to make up a lot of ground here. That's why we will not be able to overtake it as quickly as we would like. We are certainly working toward that target. We may be lucky. We may get a sharper rebound in this economy than many expect. If that were to happen, we could get there faster.

What I'm saying, Senator, is that the right way to go about this and to eliminate the deficits is not to increase taxes; it's to concentrate on what can we do to cut down the size of the Federal Government.

Senator **Proxmire**. I agree with that and I have been advocating that and voting that way and I think many of us have, and I think the President deserves credit for what he's been able to do in slowing it down. It wasn't easy and he accomplished something in 1981. But I think that the fact that we have this deeper recession than expected and the assumption on the part of many competent people—Henry Kaufman and others—that we are going to have very great difficulty pulling out of it with a healthy recovery, is because we face big deficits. We face the prospects that interest rates are going to do exactly what they did in 1980 and 1981, which is to rise sharply as soon as we start pulling out of the present recession. When that happens, of course, it means we can't have a healthy housing industry or a healthy automobile industry. It's going to be very, very hard to make progress. And, as I say, it is not just a theory; it's something that happened as a matter of fact in 1980 and 1981. Isn't that right?

Secretary REGAN. Yes, but it didn't happen in 1974, 1975, and 1976, as I pointed out, when we came out of that recession, and again I submit the reason it didn't happen in those years was that we had less money supply in 1974, 1975, and 1976 and a greater savings rate. I think those are the twin things that we have to have in order to come out of this recession without having higher rates of interest.

Senator PROXMIRE. Well, the Federal Reserve Board has, would you agree or disagree, been able to cut down the rate of increase of supply of money in 1980 and 1981 and into 1982 with some fluctuations week to week, but by quarters and by year they have succeeded in doing that?

Secretary REGAN. I would agree with you year by year, Senator, but not quarter by quarter. When you look at plus 13 percent in the first quarter of 1981, zero or negative for two quarters, and then again 13 percent in the final quarter, quarter over quarter they didn't accomplish it; but year over year they did.

Senator PROXMIRE. You indicated to the committee last year that the Reagan economic program was not based on any econometric model. You said you had one but you didn't have the time to work it out. This year you have had a year. You have had this program before you. Have you been able to put the ingredients of the Reagan economic program, including the tax cuts, including the spending reductions, into your model and have you been able to come up with an indication of what's going to happen to GNP, inflation, unemployment, and so forth?

Secretary REGAN. We don't have any final answers. We are still experimenting with the model. I wouldn't want to reveal it. As you know, any software program of that magnitude is bound to have a lot of blotches in it. We are trying to get the blotches out of it. We have had the first few runs and they haven't proven satisfactory to the imputers of the data.

Senator PROXMIRE. Haven't proven satisfactory because they show high unemployment?

Secretary REGAN. As a matter of fact, it showed too good in some cases and they just wouldn't be believable. So they have gone back to find out the problem in the software.

Senator PROXMIRE. Would you provide the committee with the details as soon as you can?

Secretary REGAN. I certainly will.

Senator PROXMIRE. They would be very helpful and we rely on you and you have highly competent people, as Congressman Richmond said.

Secretary REGAN. I would be glad to.

Senator PROXMIRE. You're familiar, I'm sure—you probably made the recommendation that we have a minimum corporation income tax. It seems to me that's a tax increase, a tax increase I'll support and vote for, but it's a tax increase, is it not?

Secretary REGAN. Yes. A rose by any other name, whether you call a tax enhancement or close the loopholes in the Tax Code, it's a tax increase.

Senator PROXMIRE. President Reagan said we won't have any tax increases and yet there's $12 billion more in 1983 and $12 billion in 1984, at least $24 billion during that 2-year period. How can you do that without a tax increase?

Secretary REGAN. What we're saying is some of these tax breaks for certain types of industries at this point are no longer needed to provide the incentives for that industry as previously because the Congress passed the Economic Recovery Tax Act. They have been overtaken by these things.

Now the minimum tax is an interesting thing and why do we put that in? First of all, it's already in the code, as you know, both for individuals and for corporations. There's a 15-percent minimum tax. You have to take your tax preference items such as depletion and add it back in.

Senator PROXMIRE. I assume you're going to make it effective because it hasn't been very effective before.

Secretary REGAN. It's effective, but there have been very few items of tax preference that have been added in. Individuals have to take more in the preference items than corporations. You have to add that in to look at your minimum.

Now to the extent that we have given enormous breaks to business in the accelerated capital recovery system, to the extent we have given added investment tax credit, to the extent we have given added leasing privileges and the privilege of swapping leases and the like, we think at this point that notwithstanding that, all corporations in the United States, unless they are really losing money, should pay some type of income tax, a fair share, if you will.

Senator PROXMIRE. Can you give us some idea of what the percentage would be?

Secretary REGAN. Fifteen percent. All we're doing is leaving what's in the code, but just adding other preference items to it. We are not changing the code to that extent. We are just taking what we have and building on it and we are not changing the rate.

Senator PROXMIRE. How much will that yield? Can you estimate what that will yield on an annual basis?

Secretary REGAN. Depending on the year it starts. If it starts January 1, 1983, the first year, fiscal 1983, will probably produce somewhere in the neighborhood of $2 to $2.5 billion in additional revenues. In fiscal 1984, it will add about $4.6 billion and in fiscal 1985 it will add $5.1. This is just the minimum tax.

Senator PROXMIRE. That's disappointingly small.

Thank you, Mr. Chairman. My time is up.

Representative **Reuss**. Congressman Wylie.

Representative **Wylie**. Thank you, Mr. Chairman.

Mr. Secretary, I'm glad to see you again this morning after last evening and again this morning via the "Today Show." I know that you were interviewed on that.

Secretary **Regan**. We're going to have to stop meeting this way.

Representative **Wylie**. I thought you did very well on the "Today Show" and very well again here this morning.

I thought the President's speech last night was outstanding and historic in developing the agenda for the 1980's. He demonstrated once again that he is a great communicator. I might say that my phone has been ringing off the hook this morning in support of his program.

Secretary **Regan**. I'm happy to hear that.

Representative **Wylie**. I think I would be remiss, however, if I did not suggest that I'm a balanced budget devotee and have been since I came to Congress several years ago, and the prospect of a $100 billion deficit this year and I think you mentioned the possibility of a $90 billion deficit next year and maybe an $80 billion deficit the next year——

Secretary **Regan**. I think the actual figures will be lower than that, Congressman Wylie. What the President said last night was it would be less than $100 billion in 1982. My own feeling would be that it would be coming down at $10 billion or more in the outyears beyond that. So it would get to less than the figures you suggested. But go ahead.

Representative **Wylie**. Anyhow, it is of some magnitude and, as I say, it disturbs me and I would have to say that during the budget debate last year we talked in terms of a balanced budget by 1984. Now you have talked about some things that have changed, conditions have changed, and one of the things you mentioned is the fact that you don't think there will be the crowding out process that we anticipated last year, that during this recession there won't be quite as much demand for credit, if I understood what you said, by the private sector and, therefore, it won't have the impact vis-a-vis the gross national product that you anticipated last year. So the mix is different. Am I reading that correctly?

Secretary **Regan**. That is correct, Congressman.

Representative **Wylie**. Now we're still talking in terms of attempting to come to a balanced budget, I hope, aren't we?

Secretary **Regan**. Oh, yes, that is still a goal of the President. He would love to see that. As a matter of fact, he would like to go beyond that and actually have a surplus and start to pay down some of the national debt.

Representative **Wylie**. Well, may I say that I'll help in any manner you would like for me to to try to come to a balanced budget, and I think from my own personal standpoint that we need to reduce the increase in defense spending in order to come to that and I think I heard you say this morning that you had favored perhaps an excise tax on tobacco and alcohol earlier but you were talked out of it.

Secretary **Regan**. No, I didn't quite say that. I was doing quite a waltz around that subject because I think——

Representative **Wylie**. You did light footwork pretty well.

Secretary **Regan**. What I was trying to do was not to disclose my advice to the President of the United States as Secretary of the Treasury. I think that's sort of privileged. But nonetheless, the President did get a lot of advice from a lot of advisers in that respect and he decided in looking at it, you know, regardless of whether you borrow it or tax it, you're still taking that money out of the private sector. He thinks that the better way to do it is to borrow it rather than to tax it out of the private sector and the thinking would be that the amount that you would raise in excise taxes, let alone the political fight—and that was beside the point—he did not approach it from that angle but nonethless let's recognize that it's there—apart from that, raising those taxes would probably produce somewhere in the neighborhood of, even if you double them, $5 to $7 billion a year. That amount of borrowing is not going to make that much difference in crowding out versus what would happen if you taxed that amount out of the system and that was the basis on which he came down. He thinks if you allow people to keep that money it will produce more revenue in the future for the Government.

Representative **Wylie**. I understand that and I was glad to see that he didn't want to reduce the tax cuts that have already been put in place.

Secretary **Regan**. No; he's adamant on that.

Representative **Wylie**. It was a productive tax cut to my way of thinking, but I think excise taxes on tobacco and alcohol, for instance, are not necessarily productive taxes as far as the private sector is concerned but it might have a desirable psychological impact in our battle to balance the budget, for whatever it's worth.

I think you're right about increasing the money supply and you touched on this again, and you have addressed the monetary policy here this morning. It seems to me that the monetary authorities are in a very serious dilemma. If the Federal Open Market Committee accelerates the purchase of Government securities at lower interest rates, bonds will rise in price and interest rates will fall as an immediate response to the actions of the Federal Open Market Committee. Would you agree with that?

Secretary **Regan**. Well, if the Fed increases the money supply—in recent years a phenomenon has occurred in the marketplace. The market is so spooked by that thinking that we're going to get back into inflation or that they're going to have waffling in the program or the Fed will increase too much and then have to cut back again, that, surprisingly, the 3-month CD rate or the 3-month Treasury bill rate exactly parallels the amount of money being put in. You put money into the system, the rates go up. You pull money out, the rates go down. Now logic would have it the other way, but nonetheless, that's the way the marketplace in the past year has been interpreting this.

Representative **Wylie**. So you suggest a policy of not much acceleration?

Secretary **Regan**. That's why we're trying to get it slow and steady, because these rapid changes will drive these traders to where they don't know what they're doing and, as a result, as I call it, the volatility part of the interest rate that is now being charged is growing—that premium.

Representative **Wylie**. I agree. Do you expect the recession to end soon?

Secretary **Regan**. We think that the recession will end in the spring of this year.

Representative **Wylie**. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Representative **Reuss**. Thank you. Senator Sarbanes.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Mr. Secretary, I first wanted to follow up on an exchange you had with Senator Proxmire. Do I understand that at this point the Treasury does not have on line a model of the economy into which the administration's program can be factored and projected forward?

Secretary **Regan**. That is correct. It does not have what would be in the vernacular a supply-side model.

Senator **Sarbanes**. Well, don't you think having some kind of model to make your projections is pretty important, in terms of having some view of where your policy is going and what it ought to be?

Secretary **Regan**. Yes, as a matter of fact, that's one of the first things I wanted when I came from the business world to the Treasury and found I didn't have such a model. I was shocked and called for such a model. Now such a model has never been built. There's one at Claremont that is partially this way, but a true model and an elaborate model has not been built. So that's what we're trying to do at Treasury right now and we contracted for this in the—I believe it was the late spring or early summer of 1981 and hopefully we will have it on line within a few months.

Senator **Sarbanes**. What is your view of the relationship between the money supply and interest rates?

Secretary **Regan**. I think it's a pretty close relationship between money supply and interest rates. I think that money supply is the largest single influence on interest rates that there is.

Senator **Sarbanes**. Well, how does it work?

Secretary **Regan**. An oversimplified version would be that the less money supply you have, and if you take the other side of it, demand stays constant, that you would think that interest rates would go up. The more money supply you have, you would think that interest rates would come down again, assuming demand stays constant, and that has been during most of my career at Wall Street the path that bond traders took and money market operators took.

Now in recent years that has changed and the more money you put into the economy, the higher your rates of interest seem to go. That's what's been happening over the last year or two.

Senator **Sarbanes**. Do you think the Federal Reserve has been pursuing, broadly speaking, an appropriate monetary policy?

Secretary **Regan**. Pursuing—I would say, yes, in general, we agree with their targets, if you're talking about what their targeted areas are. Now how they actually get to their targets, we disagree with. Last year I had a little bit of fun with Paul Volcker. I used a gold simile to try to explain this. I don't know whether the Senator is a golfer or not and I'll try not to bore him with a golf story, but what I tried to indicate was I wanted him to play in the fairway and not overshoot one way, let's say hooking it into the left rough and then slicing into the rough on the right, but stay within the band, the target, the fairway, that they had subscribed to.

Senator **Sarbanes**. Why do you think that the interest rates in relation to the money supply are defying logic?

In the traditional analysis, the cost of money is determined by supply and demand. If you restrict the supply and the demand remains constant—let's take that as an assumption—the cost will go up. You say it's defying that logic. Why is that the case?

Secretary **Regan**. Because the twin fears that both those who invest money and those who make markets in money have about: One, inflation and two, the cost of money itself. One is the inflation premium that's built into it. It used to be traditionally, as you well know, 3 to 4 percent. Right now people are demanding more than that because they think we may inflate this economy.

Senator **Sarbanes**. Is the fear of inflation that you have just spoken about related to the size of the Federal deficit?

Secretary **Regan**. Partially, yes, but not primarily.

Senator **Sarbanes**. If it's related to the size of the Federal deficit what does it profit you to support a monetary policy that puts interest rates at such a level that they contribute to the economic downturn and to the recession and thereby, as you point out in your own statement, worsen the Federal deficit by some $25 to $30 billion for each additional one point in the unemployment rate?

Secretary **Regan**. Well, first of all, we did not call for that downturn in money from April through October of 0.9 percent. We were asking at that period that the money supply be somewhere between 4 and 6 percent.

Senator **Sarbanes**. You wanted it expanded?

Secretary **Regan**. You will recall I was taken to task by certain members of the press and others for calling for an easing in the money supply last September.

Senator **Sarbanes**. How do you reconcile that call on your part for easing the money supply with the proposition you have just put to the committee, that the situation is not working logically and that apparently the way to get interest rates down is to tighten the money supply?

Secretary **Regan**. I was defining the normal practice in trying to correct it before it became to much embedded. Again, you could see when the money supply was tightening that way that we would be heading into a deeper recession.

Senator **Sarbanes**. I note in your prepared statement you say at one point that without spending restraint and faster real economic growth it is doubtful we will ever see a balanced budget. I was interested to see the two factors here. If we were at a 5-percent unemployment rate today, would I be correct in saying, keeping other things constant, that we would have a balanced budget?

Secretary **Regan**. That is correct.

Senator **Sarbanes**. Shouldn't that make it a priority to put our people to work, and doesn't your support for a monetary policy which has, in my judgment, thrown people out of work run directly contrary to that objective?

Secretary **Regan**. Well, first of all, you have to assume that we supported this very, very tight money that led to this and we didn't, and I indicated further that I called for an easing of that earlier. Second, we're trying our best to get out of this recession, not with a quick fix, but with the programs that we have in place—the tax cut and hopefully a slow, steady growth in the money supply, together with increased savings that will help to get interest rates down, and to allow manufacturers in the service industries to start borrowing money again in order to start hiring.

Senator **Sarbanes**. Mr. Secretary, I find that kind of wait-and-see attitude very troubling. Let me ask you this final question.

During the recess I held visits around my State and talked with my constituents. One fellow came in to see me with his wife. He had had 18 years of steady employment. He's been laid off. His wife has been laid off from her job. She had had a steady employment record, so we're not talking about marginal people in and out of the work force. They have now just about used up their unemployment benefits which have been limited to 26 weeks under the administration's program. They are out every day looking for a job and can't find one. They have started to sell their household furnishings in order to meet their mortgage payment. What do I tell them?

Secretary **Regan**. Well, first of all, I feel very sorry for anybody in that position. It's a tragic situation. I don't think, though, that a quick fix attempt by the Congress would alleviate it. I think there is hope that our program is going to work, and work shortly. From the point of view: Is there anything we could do, any magic that we could exert, any type of congressional appropriation type bill that would go through that would help in this situation? I don't know any. I think at this particular time, if the Congress would start now, before the program could be put into place it would be August, September, or October, and hopefully, by that time, we will be well out of the recession.

Senator **Sarbanes**. Mr. Secretary, these people are liquidating what they have managed to save and accumulate over a lifetime of hard work. I mean, I wish you would have been there. I would have liked to see his reaction to that response. You might have needed some help to control his reaction. But it doesn't seem to me to provide that person any consolation. It's a very human story and it's not isolated. It's happening all across the country in literally thousands of instances. What do we say to these people? They have worked hard to help build the country and they have now been thrown into a position with absolutely no recourse.

Secretary **Regan**. Senator, I have been there. You're not telling me a new tale. My own father was out of work and I have been there. I'm a child of the Depression. I know exactly what you're talking about. My heart is very sympathetic to these people.

What I'm saying is we're doing our best to get them out of that situation. What can be done to remit it, I don't know. What type of work programs are there in that area, if any? What type of skills do they have? What other types of things can be done? I'd want to go into all of that with that person to see where they could be employed. There are jobs, not many. They call for different type of skills, but you have to take a look at that entire situation.

Senator **Sarbanes**. Well, Mr. Secretary, there are jobs. I looked at those want ads in the newspapers. You've got to have computer skills or engineering skills or a lot of other pretty highly trained skills to respond to most of those want ads. You don't take the 24 pages of want ads in the newspaper as disproving the proposition that there's been a very sharp and disturbing increase in unemployment and the difficulty of finding a job in this country, do you?

Secretary **Regan**. No. Far from it. But if you will notice what's been happening in applications for unemployment insurance, they have been on the decline from January 1 after that initial burst. We are hopeful that maybe this is an indication that the worst of it is over. I don't know, but we are certainly trying to get out of this as quickly as we can.

Senator **Sarbanes**. My time has expired. Thank you.

Representative **Reuss**. Thank you. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman, and welcome to the committee this morning, Mr. Secretary.

I would join with my colleagues that compliment the President's speech last night and to carry on where Congressman Richmond was asking you questions and you were discussing about savings rates and what the President is trying to do is carry this deficit with savings. I was kind of hoping that he would have last night called for moving the tax cut up to January to get on the offense on the question, whether or not that could be accomplished. There has been considerable discussion in the Congress on both sides of the Hill as to whether the tax cut was too much and whether it should be this or that, and all the discussions about trying to fill that deficit by raising taxes and so on. I certainly commend you and the President and those of you who had a hand in this to not try to balance the budget by raising taxes because my experience in this town is that Congress will spend every dime it can get its hands on and then a few extra billions, and that's probably going to be the case as long as we operate under the system we do in this country. So I commend you on that.

But is there any consideration in the administration for moving those tax cuts up to generate more liquidity in the private sector?

Secretary **Regan**. It was considered, Senator, and then in view of the time factor, both on the part of the Congress and its calendar and the administration and what would have to take place on this, it was decided that it would be best to just leave it in place because there were some tax cuts going into effect on January 1, anyway, as you know, particularly the marriage penalty tax, and with 64 or more percent of the labor force now being women and better than 60 percent of the households having two wage earners it was felt there was a tax cut there for a lot of people and therefore wouldn't be productive to try to change that rapidly and go through a major fight on that provision, just leave it in place and that would accommodate the others who need tax cuts.

Senator **Symms**. My personal opinion is that the IRA's that are in the tax code now are going to encourage a lot more savings than even the most optimistic people would estimate and that there will be a big increase in savings and you can't look in the paper or hear the radio where somebody isn't advertising for people to start diverting some of their earnings into IRA's and to deferred income. I do hope that's the case and I would assume Treasury would agree with that.

Secretary REGAN. Oh, yes. As a matter of fact, the initial indications we have from the banking community are that they are going over very well and that this will be a tremendous source of new savings.

Senator SYMMS. Well, I'm glad to hear that. Now the President mentioned last night and you mentioned here about minimum tax on corporations of 15 percent. That's a minimum tax of what? Fifteen percent of what?

Secretary REGAN. Well, it will be on the tax preference income of the corporation. As you know, it's in the tax code now and is on the books, a 15-percent minimum tax for corporations and individuals whereby you figure your tax in the normal way and then you go back and add back in all the preference items as stipulated in the code. Currently there are about three or four different items that are stipulated for corporations now—the excess amortization, depletion, and there's something in there as I recall about rolling stock—excess amortization of rolling stock—things of that nature—you add it back in and take 15 percent of that and see how that compares with the tax that you otherwise would be paying and you pay whichever is higher. The same thing will be done now. There will be no change in that aspect of the code, but we will add certain other preference items that are already in the code to the list of things you will have to consider before paying a minimum tax.

Senator SYMMS. I guess my concern about that is I hate to allow Ronald Reagan to get engaged in that age-old argument that somehow you tax corporations where I think we all know that people pay taxes and corporations just collect them, and I hate to see him get, so to speak, drug into that misinformation that goes out to the public.

Secretary REGAN. Well, I can assure you, Senator, there's no misinformation on his part or mine. We understand the economic arguments of this. At this point in time, however, we are convinced that with the huge deficits and the like, the idea of strengthening the minimum tax provisions of the code for corporations is advisable.

Senator SYMMS. Well, with respect to the other side of the coin which I would say the only—if there is any good thing about having a deficit—and I don't like deficits either and have always been opposed to them as you know—it does have a tendency to encourage Congress to spend less money. Now with 60 percent of the budget dedicated to entitlement programs and the President mentioned last night $63 billion in reductions in future increases, I believe it is in entitlements in what he's talking about—when can we expect to get a really more aggressive attitude toward those entitlement programs, since the biggest part of the budget it would appear to me—that would be the place to make the biggest overall reduction. When can we expect a more aggressive program on that?

Secretary REGAN. First of all, as you know, social security which is the largest of the entitlement programs, we will propose nothing be done there until such time as the commission makes a report.

Senator SYMMS. Which will be when?

Secretary REGAN. I think the commission report is due by the end of the year, but let me check that.

Senator **Symms**. End of 1982?

Secretary **Regan**. It's toward the end of 1982 that the report is supposed to come out and obviously this then will be ready for legislative recommendations a year from today.

Now as far as the other entitlements are concerned, the President said last night that they are proposing a reduction in those of $63 billion over the next 4 years. That will be translated into legislation and submitted to the Congress probably in the February-March period.

Senator **Symms**. Of 1983?

Secretary **Regan**. Of 1982. You will see those proposals.

Senator **Symms**. Good. Well, I appreciate that. I'm very, very concerned about the liquidity of the private sector and that's why I hesitate to see anybody talking about any tax increases, because no matter whether it's a loophole, trying to change the leasing rules, minimum tax on corporations or whatever, excise taxes on tobacco and alcohol and so forth, whatever it is, it still takes money out of the private sector and the private sector is very illiquid.

Secretary **Regan**. I would agree with that, Senator, except that I think in the case of these minimum taxes on corporations, if you figure that they are going to be just on preference items and at the rate of 15 percent, the effective rate of that corporation would be less than 15 percent, so I don't think to that extent it would destroy the liquidity of that particular company.

Senator **Symms**. Mr. Secretary, I believe my time is about up, but I would just say in closing that there's one other question. Senator Abdnor talked about the illiquidity in agriculture today and has the Treasury done any analysis yet—or maybe it's too quick to ask this question—about the liquidity of the commodity markets? As you know, I was for the tax bill but I was not for that section of the tax bill which changed the tax and the rules on commodity trading because I believe that it's taking liquidity out of the commodity markets which I think is harmful to the farmers and the producers of minerals in the country. Have you had opportunity to analyze that liquidity and also the fact that now you have total neutrality on the commodity tax preference for a trader, so there's no advantage for the trader to be long any more as opposed to being short, and so that doesn't help the farmers either because as farmers we like to have the traders trying to be on the long side because it tends to push the prices up. Have you had a chance to analyze how this is working?

Secretary **Regan**. We are in the process of analyzing that. I haven't had any final answers, but let me suggest that in my discussions with Senator Abdnor I think one of the great ways to get more liquidity back into the market is to get some price movement, particularly on the up side. I think were that to happen liquidity would return very quickly to the commodity markets, but as long as we have commodity prices going down it has always been my experience in the commodity markets that doldrums follow down markets and the more active markets are those on the up side.

Senator **Symms**. Thank you very much. I think my time has expired, Mr. Secretary, and good luck to you in the coming months.

Secretary **Regan**. Thank you, Senator.

Representative **Reuss**. Representative Heckler.

Representative **Heckler**. Thank you, Mr. Chairman.

Mr. Secretary, it's a pleasure to have you before us today. My phone has also been ringing a great deal with responses—and, of course, I think we do have probably one of the greatest communicators we have had in the 16 years I have been in Congress.

I wanted to make one point that has come out through conversations with my constituents. Last night's address was listened to by a vast audience and it was pondered very carefully in terms of phrases and points that were taken to heart by the American people. There's one reference in the speech which my constituents spoke about quite a bit. They were expressing a sense of relief when the President said we will not forget, and we will continue to protect, the elderly and the poor, and that commitment is a very, very important one.

I'd like to give the administration very high marks for what you have achieved on inflation. I think too little attention has been paid to this. Some of my colleagues seem to forget that just a year ago the American people were living with a 17-percent inflation rate. That was the issue before the committee on many occasions and it was a situation that was eroding the savings of everyone and causing concern to virtually every segment of our population, especially the elderly, the pensioners, the young families. I think the improvements in the inflation rate are very, very impressive. I personally am not wedded to the idea of a balanced budget as the most important fixed goal of the United States. I think it is an important goal, but I personally feel that we need most to be moving in that direction. As I see progress on inflation going down and hopefully on interest rates going down and on economic growth going up, I think those things will be more important goals than necessarily a balanced budget, as important as that is. If they all go in the right direction at the right time with sufficient strength, we are also going to probably get a budget surplus.

The difficulty does not seem to be in the long run; it seems to be in the short run. I lost hope when I saw the zig-zag policies of the past administration. This administration has set a course and there's a steady hand at the wheel. I think it also has to be a course of compassion and I think that's an important element in this. It's also a course of growth and strength in America. We in the Congress have listened to business for all these years. I have been lobbied extensively by business representatives, but if there's one bill that business said was essential, it was 10-5-3. Before this committee and Senator Bentsen we heard about productivity. What did we need in America? To increase our productivity. They wanted an accelerated depreciation bill and we gave them that. This is what they wanted. I was one who felt the tax bill was more than the situation required. I objected to the oil provisions. I wish that the Democratic Party had given us a chance to vote on the oil provisions and I would have been happy to vote no. We didn't get that opportunity but the fact is that the centerpiece of the economic recovery program—from the tax aspect—were the individual tax cuts and the business tax cuts.

Therefore, Mr. Secretary, I'm a little disturbed at the sympathetic note in your prepared statement today where you say, "I know too that there's been concern over the apparent reluctance of business to plunge ahead with new investment. Let me express my concern with those remarks. It is not surprising that some businesses are holding back until they are certain it is safe to proceed."

Now really, when did business get the idea of a guarantee that this was to be a risk-proof world? We in the Congress have done what business asked. We have given them the tax break they needed. What happened to the great American entrepreneural spirit? Where is their confidence in what they asked us to do? Isn't there something more? Where are the jobs Senator Sarbanes spoke about? Are we going to have a CETA program or is the private sector going to respond and, if so, when?

Secretary **Regan**. I think I can assure you that the private sector will respond. They are responding in part now but not to the extent that we want. Plans for spending are up slightly but only as much as the inflation rate is up. So there's no real growth as yet.

I think one of the things you have to consider—I know if this were a time past or if I were in a different capacity as I had been I would be thinking to myself, wait a minute, how much profit can I make with interest rates being where they are now? If you start to construct a building, if you're going to have to pay 16, 17, or 18 percent for your construction money and then you're going to have to finance that over a 15-year period at again 15 to 16 percent, can you make money?

Now we're all saying—this committee, I believe—I know we are saying in the Treasury and in this administration that interest rates are coming down. I would suppose that many businessmen would say, well, let's put that on hold, our plans. They have their plans, but let's put it on hold until such time as we can see those interest rates coming down. I think as soon as you get interest rates down you're going to see this. I think the whole key to movement here is the interest rates coming down.

Representative **Heckler**. So it's very critical that interest rates come down. It's important to those who are suffering because of the interest rates, and it's important in order to develop the growth that these programs were designed to produce.

Secretary **Regan**. I think that's the No. 1 problem that we have now in this administration, how to get these interest rates down.

Representative **Heckler**. Well, then, since you see an end to this recession hopefully in the next quarter—you say 1982?

Secretary **Regan**. I said the spring.

Representative **Heckler**. Well, an economist whom I respect very much, who is chief economist for a major New York bank told me 1 year ago that we were going into a recession and that it would be a very deep one and that we would probably come out of it in the second quarter of this year. Last week he repeated that forecast. What I would like to know is, since interest rates are the key, what can be done about them, first? Second, you have predicted and forecasted the second quarter—and hopefully the earlier in the second quarter the better—but that's not too far from what I hear from the adviser who is advising me. What indicators will you be looking at to see this? What prompts you to suggest that this is going to be the turning point?

Secretary Regan. Well, I think there are two or three things that you have to look for among the leading indicators to see what's happening.

First of all, it's the course of interest rates. I think that as interest rates—when interest rates start to break it will be the ice jam and once it breaks then we're there. The second thing, I think you will see things in the service industries start to move up, financial instruments becoming more valuable. Why do I say that? Well, if you take an inflationary period, nonfinancial objectives become the greatest investment—gold, silver, land, buildings, homes, all become the objects that are acquired when you have an inflationary period. We are now in a deflationary period. One would assume that fairly soon financial instruments are going to be things that are wanted—bonds, stocks, and things of that nature. They were not wanted during an inflationary period.

As that starts to happen there you get another leading indicator of what's going on. I think if you keep your eye on manufacturers' durable goods, they have already turned for a couple months.

Representative Heckler. The orders are up for durable goods?

Secretary Regan. I think they are. That's something you have to keep an eye on. So I think over the next several months these are the items to keep your eye on to see whether or not we are going to have that recovery in the spring that we are anticipating.

Representative Heckler. Well, then, really the critical issue, above all, is the interest rates question?

Secretary Regan. Yes.

Representative Heckler. And along those lines, another one of my economist friends—I have a number of them—looks at the Fed in a different way, looking at the holdings of Treasuries and agency securities. Those were $121 billion on October 18. The Open Market purchases pushed them to $131.5 billion on December 30. Now they are down to $125.4 billion as of January 13, well above where they were this time last year. Some people—some of these economists—say this jump in the reserves is the main reason for the present excesses in the money supply. They say the Fed should stop trying to manage the money supply, should simply not monetize the debt, make the discount rate closely follow market rates, cease to target Federal funds rates, and cease to give signals to the marketplace about where the Federal funds rates should be—essentially, let the newly flexible financial institutions expand and contract reserves and money supply according to demand in the marketplace. That would take the Federal Reserve out of money management and interest rate management. Do you have any comments on that?

Secretary Regan. That person would have the banks manage money and most central bankers think they can manage money. Indeed, under the Federal Reserve Act they are supposed to manage money. To go to a completely free economy is something that is worthwhile considering and debating. But I would suggest that that is a subject that the Fed should be asked by this committee or you, with your interest in it, to give an answer to see what they have to say about it because I've heard this before and I've read papers on it and it's an interesting theory.

Representative **Heckler**. I think you're reading more and more about it all the time.

One last point. One line that was rather mysterious in the President's speech—I won't ask you to address that, but that was his reference to the elimination of unnecessary business subsidies. I hope those are not small business loan guarantees.

Secretary **Regan**. No.

Representative **Heckler**. Or DISC's.

Secretary **Regan**. No. What he's talking about there in the parlance of accountants and ordinary citizens are loopholes in the business tax code. One, for example, in the insurance industry, where insurance industries can turn premium income into investment income and taxed at a lower rate in some cases to get their investment income taxed at no rate. This through setting up subsidiaries or transferring liability for policies and the income from them between insurance companies. I think this was an unintended result of the Tax Act of 1978, so much so that insurance companies now are paying 60 percent less in taxes in 1981 than they were in 1979 as a result of the buildup in this.

This has been a great bonanza for the insurance industry but I think it's an unintended result. To them, it's a tax break. To others, it's a loophole. It's one of the suggestions we will be making to the Ways and Means Committee and to the Finance Committee of the Senate that this is something they should consider closing in the tax code.

Representative **Heckler**. What would that do to revenue if that would pass?

Secretary **Regan**. Somewhere in the neighborhood of $2 or $3 billion or more per year.

Representative **Reuss**. Congressman Rousselot.

Representative **Rousselot**. Thank you, Mr. Chairman.

Mr. Secretary, we do appreciate your being here today and giving us such a complete analysis of how you feel the economic recovery program is going to work, and why the economy is where it is today. I tend to agree with you that the Federal Reserve Board must conduct monetary policy properly by staying more in their targets than they obviously did last year. As you pointed out in your testimony, their control of the money supply has been pretty erratic and we are now paying the price for that. I think you're wise to point it out as carefully as you did.

It's difficult to explain to people in general when the incentives that we placed in the tax act are going to begin to take effect. I know you have talked about that a little bit today, but since you come from the investment community you're one that has been there before. What is taking them so long to begin to move? Now I know you talked today that there is movement to some degree, but how long does it take us to see real results at the national level after the investment community begins to take advantage of all of the incentives that we worked so hard to put in place?

Secretary **Regan**. It's a good question, Congressman. My own analysis of that would be, first of all, as I told Representative Heckler, that high interest rates really are something that would hold back almost any entrepreneur, particularly one that borrows money in order to get leverage in his or her investments. So accordingly, until we get interest rates down, you won't get the real results that we should be getting from the changes in the tax act.

Representative ROUSSELOT. Well, if you were making judgments today and I'll let you finish the answer, when do you think those interest rates are going to come down?

Secretary REGAN. My guess would be—and our forecast is that they are going to gradually recede starting in the late winter and that they are going to gradually recede over the rest of the year and will be down several percentage points by the end of this year.

Now from the point of view of the other thing I was going to talk about was that an entrepreneur, again looking at the demand side of his product mix or his service, would have to consider that we're in a recessionary period with no real sign of an upturn yet. We are all looking for that first robin, whether it's plant equipment investment, which seems to be a little bit on the upswing, but whether or not these are really the indications that we're in the trough of the recession has not really been felt yet by people. As soon as that happens and they can see ahead that we are coming out of it, then—and as interest rates come down, the two combined together, that's when you start to get your real recovery.

Representative ROUSSELOT. I know you have been participating in a package of recommendations to Congress on changes in taxes. We now refer to it as revenue enhancement, an interesting phrase—did you coin that or somebody else?

Secretary REGAN. I'm not sure who coined it.

Representative ROUSSELOT. It's catchy.

Secretary REGAN. Descriptive.

Representative ROUSSELOT. For those of us that support lower taxes, revenue enhancements are difficult to deal with. You aren't considering reviving the old discarded Carter policy of withholding tax on dividends and interest, are you?

Secretary REGAN. Yes, I am.

Representative ROUSSELOT. Well, I hope you drop it quickly. I don't think Carter had two votes on the Ways and Means Committee and since it has to originate there I hope you will get rid of that proposal.

Secretary REGAN. Well, let me explain a little bit about that, Mr. Rousselot.

Representative ROUSSELOT. Well, you weren't for it before.

Secretary REGAN. No, I know, and I was head of a firm that had 2.5 million customers, but you know when you analyze what's going on here in this area, we have analyzed it at the IRS, and from the reported dividends and interest of corporations and others to the IRS, and the reports that we see on individuals or on other tax reports that have come to the IRS there's a loss of about 9 to 16 percent of all the taxes due on interest and dividends. You talk about the underground economy. One of the greatest losses to the revenue to the IRS is right there, the failure of people to report the taxes due on interest and dividends. It's a mammoth job to go through the computers to match up what is being told to us as reported and looking at individual returns to see if indeed they were reported. A lot of this is hand done.

Now to one who comes from an area who knows that if these reports are being submitted electronically to the IRS, that is the big banks, major corporations, people like that——

Representative ROUSSELOT. The securities business?

Secretary REGAN. The securities business.

Representative ROUSSELOT. They're looking forward to paperwork?

Secretary REGAN. They're not looking forward to the paperwork, but I think that reason would have to admit that for us to collect that type of money rather than to increase taxes or rather than to have these big deficits, I think the tradeoff is worth it.

Now I know it's a tough thing. I have been told by everybody that I'm putting my head into that marble wall behind you in trying to get this through, but I think reason alone would tell us that. Now we aren't going to examine elderly people. We're not wishing to tax the older person who's receiving something on interest and dividends and living on that. That's not our intent and yet that's the example that's always thrown up to me. Are you going to tax that little old lady who gets $300 a year in interest and make her do this? No.

Representative ROUSSELOT. Funny you should bring that up. We all heard from them you know.

Secretary REGAN. I know and we're taking them out.

Representative ROUSSELOT. And there's a lot of them out there.

Secretary REGAN. And we're taking them out of our proposal.

Representative ROUSSELOT. How will you exempt them?

Secretary REGAN. By saying that anybody who has—that are paying a tax of $500 or less can certify to the institution from which they are receiving interest or dividends that they are exempt from this. That means anybody who gets $15,000 a year or less would be exempt from this.

Representative ROUSSELOT. Well, as one member of the Ways and Means Committee, you've got a long road to hoe.

Secretary REGAN. I know. I'll have to work hard.

Representative ROUSSELOT. I'd appreciate you changing your mind back to your previous position.

Secretary REGAN. I have the hat of the tax collector on and I'm looking at these deficits and ways to close them.

Representative ROUSSELOT. Are you going to reorganize the alcohol and beverage operation?

Secretary REGAN. Yes. We are in the process of doing that.

Representative ROUSSELOT. How soon can we expect an announcement on that?

Secretary REGAN. Well, we have already announced that we are going to do it. We are in the process.

Representative ROUSSELOT. I mean the final announcement of the reorganization.

Secretary REGAN. Well, we are going through this process now of seeing what's the best way from the Federal employment agents of accomplishing this. In the long run what we intend to do is to put the agents from Alcohol and Tobacco, the collection part, into the IRS and the other agents, some into Customs and the Firearms people into Secret Service.

Representative ROUSSELOT. Mr. Chairman, I have an opening statement that I'd like to insert in the record.

Representative REUSS. It has been submitted for the printed record.

Mr. Secretary, I know you have to depart so I'll ask just one question, that on the New Federalism which you tell us will turn over to the States full responsibility for aid to dependent children and for food stamps and will provide the money by taking from the cities money now allocated toward their revenue sharing community development block grants and urban development block grants.

Won't this, one, prove a very considerable burden on our cities; and second, having in mind what the President has said about our mobile Nation and people voting their feet, won't this abdication of Federal responsibility and giving it to the States induce numbers of welfare recipients to vote with their feet by going to States with adequate food and health care programs and businesses vote with their feet by leaving States which provide such programs and of course are taxed for them?

Secretary REGAN. Let me put your fears to rest, Mr. Chairman. The revenue sharing program which is administered by the Treasury for some 39,000 cities and town and sewer districts and educational areas and the like is not going to be abandoned. It will be folded into this program in its entirety and at the same rate, $4.6 billion per year. That will be an automatic pass through of these funds to the cities and town in the same amounts as they are now getting. This will continue from 1984 through 1987.

Representative REUSS. What about community development block grants and urban development block grants?

Secretary REGAN. Those type of block grants we are funding when they go into the program they will be funded in the program which starts in fiscal 1984, October 1, 1983, at the same rate that they have been funded at the 1983 level, at the fiscal 1983 level. So it's a swap of a dollar for dollar for programs at present cost and the amounts that will be turned over to the States.

Representative REUSS. But the poor city which relied on community development block grants and urban development block grants won't get that. The State will get it.

Secretary REGAN. We think that's why we're leaving a year and quite a few months for the cities and States to work that out. We know in giving this to the State that where the money has to be passed through and as long as that program is in effect the money will be going into the trust fund of Treasury earmarked for that program and when the State gets that money it has to pass that money to the city if that's indeed the program they are getting money for.

Now if the State decides to opt out, it can only opt out when the Governor or the legislators, the county and the city officials all agree they want to opt out of a program and they so tell us at the Federal level. So there will be no chance that the cities could be had on this.

Representative REUSS. I wish there were more time to explore it and I do have a note from my friend Steve Symms wondering if there's time to ask another question. I'm going to leave that to you.

Secretary **REGAN**. He can ask the question if he doesn't mind a brief answer.

Senator **SYMMS**. Thank you, Mr. Chairman.

Mr. Secretary, I would just say along with Congressman Rousselot on that withholding tax on interest and dividends, if we just lower the rates, the underground economy would be less of a problem in all areas of our Tax Code. They have been too high. That's why we have an underground economy and some of us have been saying that for years.

Secretary **REGAN**. My answer to that is yes.

Senator **SYMMS**. Right. We've got this big debt and we're having problems financing it. You and I have discussed this in the past, the possibility of making the debt a permanent debt so it would be more manageable and maybe we could manage it with less cost than Treasury continually refinancing that temporary debt. Can we expect support from Treasury when a move is made in the near future on the Senate Finance Committee to try to make that debt a permanent debt?

Secretary **REGAN**. Yes, you can, because that's already in the House and very frankly the idea of the Secretary of the Treasury having to come up cup in hand every so often and begging for an extension of that debt ceiling is not something that I really enjoy. So you will find my full support for any endeavors you make along that line.

Senator **SYMMS**. I thank you very much. Thank you, Mr. Chairman.

Representative **REUSS**. On that dividend deal, I'm afraid you will have to put Symms and Rousselot down as doubtful. Thank you very much. You're a favorite of this committee and we appreciate your being here.

We now stand in recess.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 10, 1982.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. DONALD T. REGAN TO WRITTEN QUESTIONS POSED BY SENATOR HAWKINS

Question 1. President Reagan last evening stated that the task force on fraud and abuse had saved the taxpayer some $2 billion. How was this figure arrived at?

Answer. During the six month period ending September 30, 1981, the Inspectors General in eighteen departments and major agencies saved the taxpayer over $2 billion:

Over $406 million was recovered by the Federal Government.

Over $1.7 billion in expenditures was avoided.

These savings resulted from audits that reviewed agency programs and operations and examined the records and performance of grantees, borrowers, and contractors in accordance with generally accepted auditing standards.

The attached fact sheet released by the President's Council on Integrity and Efficiency provides additional information on the government wide activities of the Inspectors General during the July-September, 1981 period to combat fraud and waste in the federal government.

EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

FACT SHEET—SECOND CONSOLIDATED REPORT OF THE INSPECTORS GENERAL ON WASTE, FRAUD, AND MISMANAGEMENT

Summary: The President's Council on Integrity and Efficiency today released its second consolidated report on waste, fraud and mismanagement. The report highlights the government wide activities of the Inspectors General during the six month period ending September 30, 1981. The report shows $2 billion in savings achieved by the Inspectors General in their efforts to combat fraud and waste in the Federal government.

Background: The President's Council on Integrity and Efficiency was established by Executive Order on March 26, 1981 to strengthen the Inspector General program and to spearhead the Administration's campaign to reduce fraud and waste in Federal programs and operations. Council membership includes the Inspectors General of all major departments and agencies as well as representatives of the Departments of Defense, Justice, and Treasury, the Federal Bureau of Investigation, the Office of Personnel Management and the Office of Management and Budget.

The semi-annual report released by the Council shows a 46 percent increase in recoveries, a 5 percent increase in indictments, and a 28 percent increase in convictions over the past six months. As a direct result of IG efforts:

Over $2 billion in savings are reported including: over $405 million recovered by the Federal government; and over $1.7 billion in costs avoided;

There have been 1,179 indictments; and

657 convictions have been handed down.

These accomplishments are positive evidence of an increasingly effective antifraud and waste program in the Federal government.

Training—to develop investigation, audit, and executive management training programs tailored to the needs of the IG community.

Performance and Evaluation—will devise ways to measure the effectiveness of the IG program.

Legislation—to alert the IGs to legislative proposals which potentially will affect their activities or responsibilities.

Administrative Remedies and Incentives—developing proposals to ensure that Federal employees who abuse and mismanage Federal monies and who are found guilty of illegal activity are administratively disciplined.

Other antifraud and waste efforts

The Administration is conducting other management improvement programs in addition to those of the President's Council on Integrity and Efficiency. Four comprehensive efforts have been undertaken to eliminate waste and mismanagement in areas in which problems have beset the Federal government for years.

Reducing Spending on Films, Pamphlets, and Periodicals: On April 20, 1981 the President launched this program by imposing a moratorium on new production and duplication so that a thorough review could be conducted and cost controls established. The first phase of this project produced over $100 million in savings in 1981 and 1982. A review of periodicals is now being conducted.

Debt Collection: Over $10 million is paid every day by the Federal government for interest charges on delinquent debts. To address this serious drain, the President directed the heads of Federal agencies and departments to institute more effective debt collection and credit management practices. Agencies are committed to collect $1.5 billion of overdue debts a year for the next three years.

Travel Management: Over $200 million a year in savings is expected as a result of improvements in travel management procedures. In July the President ordered changes in Federal travel management policies and practices which would streamline costs. The President also established a Travel Management Improvement Group, chaired by OMB, to propose and examine additional improvements in Federal travel management.

Internal Controls: An effective waste, fraud and mismanagement program requires effective internal control systems. Internal controls are checks and balances such as ensuring that adequate records are kept for all transactions and that computer security is maintained. The Office of Management and Budget has issued a circular requiring each agency head to establish and maintain systems of internal control.

Membership of the President's Council on Integrity and Efficiency

Office of Management and Budget
Edwin L. Harper, Deputy Director and Chairman of the Council
Department of Agriculture
John V. Graziano, Inspector General
U.S. Agency for International Development
Herbert L. Beckington, Inspector General
Department of Commerce
Sherman M. Funk, Inspector General
Community Services Administration
K. William O'Connor, Inspector General
Department of Defense
Joseph H. Sherick, Assistant to the Secretary of Defense for Review and Oversight
Department of Education
James B. Thomas, Jr., Inspector General
Department of Energy
James R. Richards, Inspector General
Environmental Protection Agency
Matthew N. Novick, Inspector General
Small Business Administration
Paul R. Boucher, Inspector General
Department of State
Robert L. Brown, Inspector General
Department of Transportation
Joseph P. Welsch, Inspector General
Department of Treasury
Paul K. Trause, Inspector General
Veterans Administration
Frank S. Sato, Inspector General
Interior 800-424-5081, 202-343-2424
Justice 202-633-3365
Labor 800-424-5409, 202-357-0227
Merit Systems Protection Board 202-653-7107
National Aeronautics and Space Administration 800-424-9183, 202-755-3402
Small Business Administration FTS 653-7557, 202-653-7557
State 202-632- 3320
Transportation 800-424-9071, 202-755-1855
Treasury 202-566-6900
Veterans Administration FTS 389-5394, 202-389-5394

Question 2. Does this "New Federalism" involve the transfer of any Treasury Department functions to the States?

Answer. The Revenue Sharing program, administered by the Treasury Department, is currently included by the Administration in the list of 44 programs that are slated to be merged into the President's Federalism Initiative at the end of Fiscal Year 1987. In addition, Treasury has the responsibility for collecting the various excise taxes that will be reduced by 25 percent per year during Phase II of the Initiative (fiscal year 1988–fiscal year 1991), with the expectation that many States will decide to raise their own excises commensurately. Hence, the responsibility for collecting these taxes will, by fiscal year 1991, have been fully transferred to the States.

Question 3. Can you foresee any external shocks such as a surge in oil prices, food prices, world political events, etc., causing a delay in our economic recovery this year?

Answer. It is always possible that one or more external shocks could occur and create supply/demand pressures on the economy. In the past, food and energy developments, to name two areas, have had such serious disruptive influences. It is very difficult to predict if or when such developments might occur, but at this time we do not anticipate any external shocks that would sidetrack the economic recovery that we expect later this year.

Currently, there is a surplus of crude oil. World oil prices rose very little in 1981 and in real terms the average world price declined. Very likely, the same conditions will prevail in 1982.

Worldwide food production has been generally favorable and stocks are ample. Weather is a critical factor in food production. It is always risky to forecast what the weather will be like, but we do not expect weather conditions to create any abnormal food developments this year.

The government is continuously monitoring the world political situation in order to be on top of important developments. Nevertheless, sudden political crises are difficult to predict. However, if such disturbances should arise, the economy is better able to cope with them when we have in place the type of sound domestic policies that President Reagan has proposed.

Question 4. If inflation comes down, the Federal Treasury suffers because of the loss of revenue due to inflation-induced bracket creep. What would be the budget effects if inflation is reduced to zero in 1982?

Answer. Two of the economic assumptions underlying the budget estimates released this week are steady reductions in the growth of inflation and nominal GNP. Underlying those decelerating trends are the assumptions of firm budget restraint and controlled expansion of money and credit, rather than the continuation of the stop-go policies of the past. Wringing out all inflation in just one year's time would require extreme, draconian measures and then, subsequent policies to temper the economic pain that would surely follow. Such a policy would amount to a replay of the unacceptable stop-go syndrome.

The sensitivity of the budget estimates to a less extreme alternative path was incorporated in the "Budget of the United States Government, Fiscal Year 1983." As noted there, inflation is expected to fall steadily out through 1987; the GNP deflator rose by 9.1 percent in 1981 (year-over-year), and by 1987 the rise is projected to be only one-half as much. If nominal GNP growth were just 2 percentage points higher each year out through 1987 than projected in the Budget (reflecting a continuation of higher inflation), Federal receipts would be enlarged by $353 billion over the five years ending 1987 as inflation and the progressive tax code pushed tax payers into higher tax brackets. By not allowing those inflated receipts or outlays to be realized, the cumulative budget deficit is raised by almost $111 billion over those same five years. Of course, the higher inflation and tax rates would result in lower real growth and higher unemployment, which would affect these numbers. Federal revenues would not buy as much as otherwise, and outlays on safety net spending would have to increase.

It is clear that the lower inflation and nominal GNP growth projected in the Budget will result in temporarily worsening the budget imbalance. However, those imbalances will be partly offset by a shift in the composition of nominal output between real growth and inflation. This shift will result from the combination of tax and spending cuts, deregulation, and restoration of monetary stability. Together, these changes will be a first step toward reacquiring the low inflation-high growth of the early 1960's, while at the same time improving the overall budget posture.

Question 5. The last economic "recovery" in this country lasted but four quarters (one year). What will make the Reagan Economic Recovery later this year any different?

Answer. Both 1980 and 1981 were years of very poor and erratic economic performance—characterized by high and rising tax rates, excessive Federal spending, erratic money growth, heightened uncertainty in financial markets, sharp swings in interest rates, and pronounced distress in interest rate sensitive sectors of our economy. The recovery from the 1980 recession was so short that the entire period since 1979 could easily be thought of as one long recession.

The underlying causes are only now being dealt with successfully. Fundamentally different policies are now in place. One critical element will be the successful pursuit of a stable, moderate rate of growth in the money supply to provide a strong base for recovery in the most interest rate sensitive areas of our economy as well as a strong expansion of the entire economy. Another critical element will be the full implementation of the incentive tax program and the program for spending restraint.

The President's four-part program adopted last summer contains the policies necessary to correct the errors of the past. And when more fully implemented, and enhanced by the initiatives incorporated in the fiscal year 1983 Budget, we are confident that economic growth and full employment can be restored even as inflation is reduced. The four interconnected parts of the President's program are well known and include:

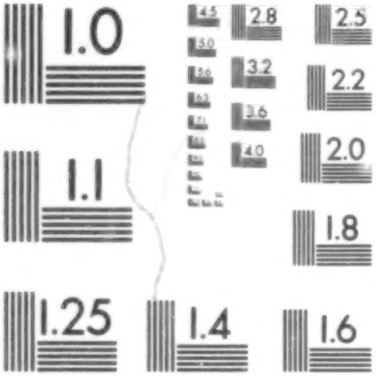
A significant reduction in the growth of Federal spending in Fiscal Year 1982 and beyond;

An incentive tax policy to encourage work effort, saving and investment;

Regulatory reform to reduce inefficiencies and unnecessary costs; and

Encouraging the Federal Reserve to keep money growth steady at levels consistent with a gradual return to stable prices and low interest rates.

○


1.0
4.5
2.8
2.5
5.0
5.6
3.2
2.2
6.3
3.6
7.1
2.0
4.0
1.1
1.8
1.25
1.4
1.6

PHOTOGRAPHIC SCIENCES CORPORATION
770 BASKET ROAD
P.O. BOX 338
WEBSTER, NEW YORK 14580
(716) 265-1600

20:1

Congressional Information Service, Inc.
Washington, D.C.

CIS